id

I will work hard, hop-
live up to the best that is in me.

I will blot out of my life the
failures that come through wast-
ed hours, and write into it the
achievements that come through
time well spent.

Young people study bookkeeping to learn how to control their personal finances and to aid them in a business career.

# *Practical*
# BUSINESS ADMINISTRATION

A Home-Study Course and General Reference Work on Business Correspondence, Office Management, Retail Selling, Sales and Advertising, Production, Economics, Business Law, Accounting, Auditing, Finance, and Statistics

*Prepared by a Staff of*
*Accountants, Auditors, Management Engineers, and Specialists in Business Methods and Administration*

OVER SEVENTEEN HUNDRED ILLUSTRATIONS, DIAGRAMS, AND CHARTS . . TWELVE VOLUMES

EIGHTH EDITION

1958
AMERICAN TECHNICAL SOCIETY
CHICAGO, U. S. A.

Printed in U. S. A.

# AUTHORS AND COLLABORATORS

BERNARD F. BAKER, B.S.

Supervisor of Vocational Business Education, Chicago Public Schools
Author of *Effective Retail Selling*
Formerly Instructor in Business, Englewood High School, Chicago

HARRY A. BATES

Retired Former Vice-President, Reincke-Ellis-Younggreen and Finn, Inc., Advertising Agency, Chicago

ROWLAND BURNSTAN, Ph.D., Sc.D.

President, Indian Motorcycle Company
Formerly Professor of Economics and Chairman of the Department, Carleton College
Formerly Director of Research, Armour & Company
Formerly Economist, United States Department of Commerce
Formerly Associate Editor, *Survey of Current Business*

JOHN A. CHAMBERLAIN, A.B., LL.B.

Attorney, Cleveland, Ohio
Formerly Lecturer on Suretyship, Western Reserve Law School
Author of *Principles of Business Law*
Contributor to Law Journals

JAY F. CHRIST, A.B., J.D.

Associate Professor of Business Law, School of Business, The University of Chicago
Author of *Fundamental Business Law, Elements of Commercial Law, Modern Business Law, Law of Contracts and Sales*
Formerly Associate Editor of *Legal Periodical Digest*
Formerly Director and Chief of Radio Code Instruction, U.S. Naval Training School (Radio) at The University of Chicago
Co-author of *Outlines of Economic Order*

RAYMOND V. CRADIT, B.S., M.A.

Member, Missouri and Florida Bars
Formerly Professor of Commerce, Northeastern Oklahoma State Teachers College
Financial Analyst, U.S. Signal Corps Price Adjustment Section, Chicago
Author of *Business Organization, Office Management, Bookkeeping for Personal and Business Use*

HENRY POST DUTTON, B.E.E.

Chairman, Department of Industrial Engineering, and Professor of Business Management, Illinois Institute of Technology
Formerly Professor of Factory Management, Northwestern University
Consultant in Management

L. E. FRAILEY, B.A.

Lecturer, Author, and Business Letter Counselor
Sales Consultant, National Association of Real Estate Boards
Formerly Instructor in Business Letters, Northwestern University
Formerly Editorial Director, The Dartnell Corporation
Formerly Personnel Director, Purina Mills

GEORGE E. FRAZER, LL.B., C.P.A.

Member of the Firm of Frazer and Torbet, Certified Public Accountants
Formerly General Auditor, Montgomery Ward & Company, Chicago
Formerly Lecturer in Accounting and Finance, The University of Chicago

## AUTHORS AND COLLABORATORS—Continued


### WILLARD J. GRAHAM, A.M., Ph.D., C.P.A.

Professor of Accounting, School of Business, and Director of Business Studies in University College, The University of Chicago
Associate, American Institute of Accountants

### GLENN M. HOBBS, B.S. Ph.D.

With W. M. Welch Manufacturing Company
Formerly Executive Director, University of Illinois Foundation
Fellow, American Association for Advancement of Science

### JAMES McKINNEY

President, American School, Chicago
Vice-President, American Technical Society
Formerly Field Director, Education and Training Section, Emergency Fleet Corporation
Formerly Assistant Professor of Industrial Education, University of Illinois

### JAMES O. McKINSEY, A.M., LL.B., C.P.A.

Author of *Budgetary Control, Managerial Accounting, Financial Management*
Late Former Professor of Business Policies, The University of Chicago
Late Former Chairman of the Board of Directors, Marshall Field and Company

### THOMAS C. ROBINSON, B.S.

Agricultural Statistician, Bureau of Agricultural Economics, U.S. Department of Agriculture
Author of *Practical Statistics*

### EARL A. SALIERS, B.S., A.M., Ph.D., C.P.A.

Professor of Accounting and Head of the Accounting Department, Louisiana State University
Member of American Accounting Association and the American Institute of Accountants
Author of *Principles of Depreciation, Financial Statements Made Plain, Accounts in Theory and in Practice, Handbook of Corporate Management and Procedure, Modern Practical Accounting*

### JOHN L. SCOTT

Director of Advertising, G. D. Searle & Company, Chicago
Formerly Editor of *The Printing Art Quarterly*
Formerly Managing Editor of *American Business*

### A. M. SIMONS, B.L.

With Bureau of Medical Economics, American Medical Association
Formerly Lecturer on Personnel Relations, University of Wisconsin
Author of *Personnel Relations in Industry, Production Management*

### MAY WOOD-SIMONS, Ph.B., M.A., Ph.D.

Author of the *Wisconsin Citizens Handbook, Everyday Problems in Economics, Woman and the Social Problem*
Formerly Instructor of Economics, Northwestern University
Member, American Economics Association and the Royal Economical Society (Britain)

### LUCIUS I. WIGHTMAN, E.E., M.E.

Industrial Counsel for Advertising, Sales Distribution, Products, Product Design, and Markets, at Gales Ferry, Connecticut
Formerly Advertising Manager, Ingersoll-Rand Company

# AUTHORITIES CONSULTED

THE editors have freely consulted the standard technical and business literature of America in the preparation of these volumes. They desire to express their indebtedness particularly to the following eminent authorities, whose well-known treatises should be in the library of everyone interested in modern business methods.

Grateful acknowledgment is made of the valuable service rendered by the many manufacturers and specialists in office and factory methods, whose cooperation has made it possible to include in these volumes suitable illustrations of the latest equipment for office use. Acknowledgment is also made to those financial, mercantile, and manufacturing concerns who have supplied illustrations of offices, factories, and shops, typical of the commercial and industrial life of America.

ROGER WARD BABSON, B.S., LL.D.

Chairman of the Board, Babson's Reports, Inc.
Founder, Babson's Statistical Organization and Babson Institute
Author of *Twenty Ways to Save Money, Consumer Protection, Business Barometers, Business and Investing Fundamentals*

ROBERT JOSEPH BENNETT, C.P.A.

Author of *Corporation Organization and Accounting*
Co-author of *Corporation Procedure*

WILLARD COPE BRINTON, S.B.

President and Treasurer, Terminal Engineering Company, Lawrence Safety Brake Company, New York
Author of *Graphic Presentation, Graphic Methods for Presenting Facts*
Member of American Society of Mechanical Engineers, American Statistical Society, Harvard Engineering Society of New York

STUART CHASE, S.B.

Author of *Where Does the Money Come From? A Primer of Economics, Idle Money, Idle Men, Economy of Abundance, Men and Machines*
Formerly with the Securities and Exchange Commission and the Tennessee Valley Authority

PAUL DELANEY CONVERSE, A.M.

Professor of Business Organization and Operation, University of Illinois
Author of *Elements of Marketing*

## AUTHORITIES CONSULTED—CONTINUED

### ARTHUR STONE DEWING, A.M., Ph.D.

President, White Mountain Water Company, Portland Water Company, Jewett City Water Company, Chatham Water Company, Hazardville Water Company
Author of *The Corporation—A Study of Its Financial Structure, Corporation Finance, Financial Policy of Corporations*
Director of Consolidated Biscuit Company, Barnstable Water Company

### EDWARD A. DUDDY, A.M.

Professor of Marketing, School of Business, The University of Chicago
Author of *Business Correspondence, Materials for the Study of Business*

### PAUL HOWARD DOUGLAS, A.M., Ph.D.

Professor of Industrial Relations, The University of Chicago
Author of *The Theory of Wages, Controlling Depressions, Social Security in the United States, Real Wages in the United States*
Member of American Economic Association, American Statistical Association

### HARRY ANSON FINNEY, Ph.B., C.P.A.

Member of the Firm of Baumann, Finney & Co., Chicago
Professor of Accounting, Northwestern University
Author of *General Accounting, Introduction to Principles of Accounting, Consolidated Statements, Principles of Accounting*
Member of American Institute of Accountants

### IRVING FISHER, Ph.D.

Former Professor of Political Economy, Yale University
Director and Member of Executive Committee, Remington Rand, Incorporated
Author of *Booms and Depressions, Stable Money, a History of the Movement, Stabilizing the Dollar, The Making of Index Numbers, The Theory of Interest*

### CHARLES W. GERSTENBERG, LL.B., J.D.

Professor of Constitutional Law, St. Lawrence University
Author of *American Constitutional Law, Financial Organization and Management*
Member of American Economic Association, American Statistical Association

### FRANK BUNKER GILBRETH

Author of *Fatigue Study*
Formerly Consulting Management Engineer
Member of American Society of Mechanical Engineers

### GEORGE CARTER HARRISON

Fellow, Institute of Management
Author of *Standard Costs, Cost Accounting to Aid Production*

### JOHN THOM. HOLDSWORTH, A.B., Ph.D.

Professor of Economics, University of Miami
Member, American Economic Association
Author of *Money and Banking*

### ROY BERNARD KESTER, M.A., Ph.D., C.P.A.

Professor of Accounting, School of Business, Columbia University
Author of *Principles of Accounting, Accounting Applications in Business and Industry, Accounting Theory and Practice*
Member of American Institute of Accountants, National Association of Cost Accountants, American Accounting Association

## AUTHORITIES CONSULTED—Continued

### FORREST A. KINGSBURY, Ph.D.

Associate Professor of Psychology and Student Counselor, The University of Chicago
Co-author of *Psychological Tests in Business*

### LEVERETT S. LYON, LL.B., M.A., Ph.D.

Chief Executive Officer, Chicago Association of Commerce
Member, American Economic Association, Academy of Political Science, and American Statistical Association
Author of *Education for Business, Salesmen in Marketing Strategy, Advertising Allowances, Government and Economic Life*

### LEON CARROLL MARSHALL, A.M., LL.D.

Professor of Political Economy, American University
Formerly Visiting Professor of Education, Johns Hopkins University
Associate Editor, *Journal of Political Economy*
Author of *Curriculum Making in the Social Studies, Readings in Industrial Society, Business Administration, The National Recovery Administration—An Analysis and Appraisal*

### WESLEY CLAIR MITCHELL, Ph.D., LL.D., D.Sc.

Professor of Economics, Columbia University
Past President, American Economic Association
Fellow, American Statistical Association
Author of *Business Cycles: The Problem and Its Setting, The Backward Art of Spending Money, A History of the Greenbacks*
Co-author of *Recent Economic Changes, Income in the United States*

### ROBERT H. MONTGOMERY, LL.D., C.P.A.

Member of the Firm of Lybrand, Ross Bros. & Montgomery
Formerly Member of Board, School of Business, Columbia University
Author of *Excess Profits and Other Federal Taxes on Corporations, Federal Tax Handbook Supplement, Financial Handbook, Income Tax Procedure*
Past President of American Association of Accountants
Member of American Economic Association and American Institute of Accountants

### HAROLD GLENN MOULTON, LL.D., Ph.D.

President of the Brookings Institution, Washington, D. C.
Author of *Capital Expansion, Employment, and Economic Stability, The Recovery Problem in the United States, The Financial Organization of Society*

### PAUL HENRY NYSTROM, Ph.B., Ph.M., Ph.D.

Professor of Marketing, Columbia University
Consultant in Business and Marketing
Past President of the American Marketing Society
Author of *Retail Store Operation, The Economics of Consumption, Economics of Retailing*

### WILLIAM ANDREW PATON, A.M., Ph.D., C.P.A.

Professor of Economics and Accounting, University of Michigan
Member, American Economic Association, Society of Certified Public Accountants, American Institute of Accountants
Editor and Principal Contributor, *Accountant's Handbook*
Author of *An Introduction to Corporate Accounting Standards, Advanced Accounting, Accounting Theory*

## AUTHORITIES CONSULTED—Continued

### WARREN MILTON PERSONS, B.S.

Member of the Firm of Warren M. Persons and Associates, Consultants in Applied Economics, New York
Fellow, American Statistical Association, Member, American Economic Association
Author of *The Construction of Index Numbers, Forecasting Business Conditions, Indices of Business Conditions*

### ROSCOE POUND, A.M., Ph.D., LL.M., LL.D., J.U.D.

Formerly Carter Professor of Jurisprudence, Harvard University
Fellow, American Association for Advancement of Science, American Bar Association
Author of *Appellate Procedure in Civil Cases, Law and Morals, Administrative Law, The Spirit of the Common Law*

### H. W. QUAINTANCE, LL.B., Ph.D.

Formerly Head of the Department of Accounting and Business Administration, American School

### CLARENCE RUFUS ROREM, A.M., Ph.D., C.P.A., LL.D.

Chairman, Committee on Welfare Accounting, American Public Welfare Association
Consultant to Federal Security Board
Director of Committee on Hospital Service, American Hospital Association, Chicago
Member, American Economic Association
Author of *Accounting Method, Hospital Care in the Family Budget*

### WALTER DILL SCOTT, LL.D., Ph.D.

President Emeritus of Northwestern University
Author of *Influencing Men in Business, Increasing Human Efficiency in Business, Psychology of Advertising in Theory and Practice, Personnel Management"*

### WILLIAM HOMER SPENCER, Ph.B., J.D.

Professor of Government and Business, The University of Chicago
Author of *Casebook of Law and Business, A Textbook on Law and Business, Law and Business, The National Labor Relations Act*

### FREDERICK WINSLOW TAYLOR, M.E., Sc.D.

Past President of the American Society of Mechanical Engineers
Author of *Shop Management, Scientific Management in American Industry, The Principles of Scientific Management*

### ORDWAY TEAD, A.B.

Editor of Economic and Business Books, Harper & Bros., Director, Harper & Bros.
Member of the American Economic Association, Association for Labor-Legislation
Author of *New Adventures in Democracy, Human Nature and Management*

### PAUL M. WARBURG

Formerly Member, Federal Reserve Board

### H. PARKER WILLIS, Ph.D., LL.D.

Professor of Banking, Columbia University
Formerly Editor-in-Chief, *New York Journal of Commerce*
Author of *The Federal Reserve System*
Co-Author of *Foreign Banking Systems, Investment Banking, Federal Reserve Banking Practice*

# FOREWORD

MODERN business places a high premium on the trained man. Of the thousands who knock each year at the portals of our commercial enterprises, the applicant with a backlog of sound training is in greatest demand.

On the job, he has a better chance for promotion than the untrained worker, because his preparation gives him a knowledge of the broad fundamentals of successful business operation.

The road to executive leadership and success in business begins with good training. All commercial and business enterprises, large and small, are governed by certain basic principles. Today's businessman must analyze his problems with intelligence and knowledge, based on an intimate understanding of these fundamentals. He must have a grasp of the whole operation of a business as well as the inter-relation of its parts.

How does he come into possession of such knowledge? Eventually by experience, yes. But he seldom gets the chance to acquire that experience without previous preparation. Such preparation can come either through study or apprenticeship, but usually it is a combination of both.

However, the great growth of business and industry, reaching new heights of expansion during World War II, has made for further specialization in the duties of business executives and subordinates. Thus it has become impossible to get apprentice experience in the numerous departments of an organization without spending long years.

Modern methods of business training have evolved sound and tested short cuts to executive leadership and business independence. A carefully planned program of study offers effective means of acquiring such training.

In the past, the man who desired to acquire this knowledge found himself wasting valuable time. For one thing, good reading material was so scattered that blind selection of textbooks was unavoidable. As a result, much duplication of

reading and important omissions gave him too much of some subjects and too little of others.

In order to offer in co-ordinated, organized form, a complete series on training for business leadership, the American Technical Society prepared this set on Practical Business Administration. Through eight editions and numerous reprintings, we have revised and added to the original texts to meet the specific needs of today's business trainee and executive.

The present set combines the collective judgment of outstanding authorities with their accumulated years of practical experience in specialized fields. Thousands already have found this set to be their first step toward successful business careers.

Prepared primarily for those who engage in independent home study, these books have been written at the college level for high-school graduates who aspire to executive positions. The style of writing is simple and readable; the lesson contents clear and comprehensive.

The businessman hard pressed for time, the fact-seeking citizen wanting the know-how of business, and the student for whom this set has been prepared primarily—all find in these books a wide range of practical knowledge and a wealth of factual material about the world of business.

WINTHROP W. ALDRICH

Chairman of the board of the Chase National Bank of New York, Winthrop W. Aldrich has had one of the most distinguished careers in the world of finance. He is the son of the late former Senator from Rhode Island, Nelson W. Aldrich, who was an outstanding authority in financial affairs. Winthrop Aldrich is a Harvard alumnus, '07 and '10 (Law School). He has been chairman of the board of Chase National since 1934; he is also a director of the American Telephone and Telegraph Company, Metropolitan Life Insurance Company, Westinghouse Electric Corporation, and Discount Corporation of New York.

*Courtesy of Chase National Bank*

# CONTENTS

## Volume IX

MODERN PRACTICAL ACCOUNTING—ELEMENTARY
. . . . . . . . . . . . . . . . . . . . *By Earl A. Saliers**



*For professional standing of authors, see list of Authors and Collaborators at front of volume.

## CONTENTS, VOLUME IX—CONTINUED

# DEBTOR
AND
# CREDITOR
## MADE EASY:

OR,

## A Short INSTRUCTION,

For the attaining the Right Uſe of

# ACCOMPTS,

AFTER THE

Beſt Method uſed by MERCHANTS

FITTED

To the TRADES, or Ways of Dealing, in theſe ſeveral CAPACITIES: *Viz.*

| | |
|---|---|
| The *Youth*, or *Young Scholar*, | The *Retailing Shop-keeper*, |
| The *Husband-man*, or *Farmer*, | The *Handicrafts-man*, |
| The *Country-Gentleman*, | The *Merchant*. |

The Fourth Edition, Corrected and Amended.

To which is Added, *Inſtructions for Rent-Gatherers*, &c.

By *STEPHEN MONTEAGE*.

*LONDON*: Printed by *T. W.* for *Benj. Billingſley* at the *Printing-Preſs* at the *Royal Exchange* in *Cornhill*, 1708.

**Title page from a bookkeeping text published in England in 1708.**

# *Chapter* 1

# USES OF ACCOUNTING

**Science of Records.** Modern business is so complicated that it is necessary to have records which not only indicate clearly all facts, but which also enable business men to make analyses and to prepare informative statements. Many people invest their money in enterprises in which they take no active part. For a knowledge of the progress made by these enterprises, the investing public is dependent on reports and financial statements. These cannot be prepared except from scientifically kept records.

This science of records is the result of a long process of growth and development. Perhaps the first scientific treatise dealing with the science of financial records was written by an Italian mathematician about the time Columbus discovered America. This book was written in Latin, but English translations thereof are available. It gives an interesting insight into the origin of accountancy and outlines the principles of double entry essentially as they are applied today.

Following the Middle Ages, there occurred in western Europe a great growth in trade and industry. This development took on even broader aspects as the American continent began to be industrialized by a rapidly growing population. England became the great commercial nation, and it is to England that we owe much for the work done in the development of the legal and financial aspects of business.

Industrialism in the United States may be said to date from a period somewhat later than the period of the Civil War. By this time the country had become fairly unified and the growth of population had made necessary a considerable degree of specialization in the various branches of agriculture, manufacture, and trade. The growth of the railway system of the United States is, in a sense, an index of the country's industrial development. As the

result of many errors and some bitter experiences, it was evident not later than the year 1880 that accountancy would soon develop into a science, and accountants would become members of an important profession.

**Need of Records in Business.** In conformity with the development of the United States, there has occurred a great growth in specialization in many fields. A few of these fields are: manufacturing, transportation, government, and agriculture. Accompanying this development there has occurred a great increase in the demand for men and women having technical knowledge of such subjects as law, engineering, and accountancy.

Modern business is carried on by means of organizations which vary in size from small units to large organizations, employing thousands of men, and involving intricate problems in management and finance. American business, moreover, is essentially competitive in character. Narrowing margins of profit eliminate inefficient enterprises and make it essential that all who expect to succeed shall have accurate and detailed information upon which to base future policies.

Under these circumstances, it is natural that those forms of business organization best fitted to perform the functions demanded of them should continue to exist. It is natural, also, that varying sizes of undertakings should require different types of organization. A grocery store with annual sales of $100,000.00 need not be organized as is a concern manufacturing automobiles, and having annual sales of $100,000,000.00. In large enterprises it may be necessary to appeal to thousands of investors. Where both large and small enterprises exist and perform widely varying services, it is only natural that business organizations are found to be classified into three groups as follows: (1) sole proprietorships, (2) partnerships, (3) corporations.

**Sole Proprietorship.** The sole proprietorship retains a position of fundamental importance in modern business, notwithstanding the great development which has taken place in the size of many business units. The small enterprise continues to be a necessity in American commercial and industrial fields. Convenience makes it necessary that the customer purchase near his home. The American

people are such extensive consumers of both essentials and luxuries that local stores and even local industries of various types are able to prosper. Under the sole proprietorship form of organization the owner of the business furnishes the capital, although in reality an important amount of capital is furnished frequently by his creditors. The sole proprietor employs whatever help is needed, and these persons remain employees as long as the organization continues to be a sole proprietorship.

The sole proprietorship form of organization has its advantages and disadvantages. Among its advantages are simplicity and, as a rule, workability. There can be no conflict of authority, since the proprietor exercises absolute authority.

There are latent, in a sole proprietorship, certain disadvantages. These sometimes become actual. To illustrate, there always is the latent possibility of the proprietor's death. Should this become an actuality, it may be necessary to liquidate the enterprise. Again, the sole proprietorship has rather limited sources from which it may derive additional funds. The most important of these is the proprietor's private fortune, distinct from his interest in the enterprise. Other sources of funds are credit extended by vendors and by banks. At best, however, these sources of funds are limited and a great demand for additional capital may meet with obstacles which cannot be surmounted.

Sole proprietorship accounting is simple in one respect, namely, that all profits and losses must be borne by the proprietor, but beyond this aspect of simplicity the accounting for sole proprietorship differs little from the accounting for partnerships and corporations.

**Partnership.** The partnership, as known in this country, is of common law origin; therefore, for precedent it is customary to look to the decisions of English courts. In the United States the common law is the basic law, except in Louisiana, and even in Louisiana common law principles apply to business to a great extent. Regarded from the point of view of its first source, a partnership may be said to owe its origin to the trading communities of Italy, but for practical purposes the English law reports contain the information needed to explain their historical background. Previous to the seventeenth century, business disputes in England were settled in

special courts known as *staple courts*, but with the decay of these courts during the latter part of the sixteenth century and the early part of the seventeenth century, partnership disputes were settled more and more frequently in the common law and equity courts of England.

Although the common law is the basic law in the United States, it has been changed in some of the states by statutory enactments. Where the so-called Uniform Partnership Act* has been enacted, its provisions supersede the common law. In general, however, where the rules of common law are applicable to modern conditions, they are incorporated in the Uniform Partnership Act, since the uniform law adopts that view which appears to be the better one.

Also a few of the states have adopted what is known as the Uniform Limited Partnership Act. Limited partnerships can exist only through statutory authorization. The primary characteristic of a limited partnership is that one or more, but not all, of the partners are not subject to the unlimited liability. In common law partnerships, each partner is liable on partnership debts to the full extent of his private fortune. By permitting certain partners to enjoy freedom from the unlimited liability rule under certain restrictions, the partnership is enabled to make a strong appeal for capital. In order to organize a limited partnership under the Uniform Partnership Act, a certificate signed by two or more persons must be filed in the county where it conducts business or has an office. The certificate must contain certain specified information, but, in particular, information relative to limited partners. Limited partners cannot take part in the management of the business. Doing so renders them liable as general partners.

The partnership form of organization is peculiarly adapted to certain types of enterprise or undertaking. Practically all accounting firms are partnerships. Frequently, professional men in other fields organize themselves into partnerships for the carrying on of their professional work. As a rule, these professional partnerships do not require the investment of large amounts of capital. Even in the

---

*The Uniform Partnership Act represents an attempt to put into statutory form such rules as are best adapted to present-day partnerships. The law must be passed by the state legislature before becoming effective in the state in question.

fields of trade, finance, and industry the partnership still fills an important place. It naturally can command more capital than can the sole proprietorship. The unlimited liability feature gives the partnership credit standing in proportion to the financial strength of the general partners. Additional partners may be admitted, either to secure additional funds or to secure additional managerial ability, or both. There is, however, practical limitation on the size of partnerships, since a large number of partners has obvious disadvantages. Partnerships require the most meticulously accurate accounts. This is because of the necessity of accurately enforcing the partnership agreement relative to such matters as interest on invested capital, loans to partners and interest thereon, drawings made by partners, etc.

As is true with any form of organization, the partnership has its advantages and disadvantages, some of which have been indicated in preceding paragraphs. These should be compared with the advantages and disadvantages of other forms of organization.

**Corporation.** The third important type of organization is the corporation. The corporation is of strictly statutory origin, that is, there is no provision for its organization in the common law. Corporations can be organized only in accordance with a special act of the legislature or in accordance with general corporation laws. Formerly, corporations were organized under special acts of state legislature, but with the growth of commercialism it has been necessary to pass general corporate laws. Each state now has such laws.

Corporations are peculiarly adapted to large scale enterprise, but the corporate form of organization frequently is used to carry on relatively small enterprises. The distinguishing characteristics of a corporation are the manner in which it secures funds through the sale of capital stock and the manner in which profits are accounted for.

The amount of capital stock which a corporation may issue is determined by its charter. Thus, if the authorized capital stock of a corporation is $100,000.00, this is the amount which it can issue. Stock issued in excess of the amount authorized is invalid. Capital stock may have either par value or no-par value. When it has a par

value this is usually, but not always, fixed at $100.00 per share. No-par value stock possesses no prescribed value. When capital stock has a par value of $100.00 per share this means, ordinarily, that it cannot be sold originally for less than that figure. No-par capital stock on the other hand can usually be sold for whatever it will bring, except that a minimum or stated value may fix the lower limit for the selling price.

After stock having a par value has been issued, it is sold and resold by investors and speculators for whatever it is regarded as worth. Only where par value stock is originally issued must it be sold ordinarily for not less than par value. A few states permit the original sale of such stock to be made at a discount.

It is evident, since units of ownership of a corporation may be $100.00 or even less in amount, that ownership in a corporation may be represented by many different stockholders. A large corporation may be owned by many thousands of stockholders.

It is obvious that the financial records of corporations must be kept with meticulous care, since there are so many interested parties. For example, there are general creditors, bondholders, and frequently two or more classes of stockholders. Sometimes the interests of these parties conflict. Each group bases its claims upon contracts which the members of the group have with the corporation. In order to supply the information needed for the satisfactory fulfillment of its obligations, a corporation must have an adequate accounting system.

**Need for Financial Statements.** Accounting records perform several important functions. They provide the information necessary for the routine management of affairs. They serve as a protection for creditors and owners. The routine entries made to record the daily transactions of an enterprise must be summarized and interpreted at the end of each year or each month, as the case may be. Great masses of detail must be reduced to the form of accurate but brief statements, which can be used for one or more of the following purposes: (1) management, (2) credit, (3) investment.

**Management.** Management consists in an adequate control of all of the activities of an enterprise. It must be centralized in a responsible head to whom all subordinate parties must report. It is

evident that management can be successful only when orders and commands can be based on accurate information regarding operating costs and revenues. This information can be secured only through the operation of an accounting system which makes it possible to report promptly all essential data relative to costs and revenues. Large enterprises must be departmentalized in order that information relative to the management of each department may be obtained readily. It is only when such information is forthcoming that unprofitable activities may be eliminated and profitable activities encouraged. An important feature in management is budgeting. Budgeting consists in planning future operations. A detailed budget consists of a forecast of costs and revenues sufficiently detailed and classified to provide information upon which can be based departmental programs.

The manager of an enterprise requires the accounting department to furnish him the data necessary for the determination of current and future policies. This means that accounting and budgeting are merely two aspects of business control. Accounting is concerned with that which has occurred. A budget is concerned with that which will occur. Both accounting and budgeting are essential to good management.

**Credit.** If it were possible to transact business on a strictly cash basis, credit might not be of great importance. The tendency, however, is to lay greater stress on credit as industry and trade become more clearly integrated. This is because it is not expected that debts incurred for the purchase of raw materials and merchandise will be immediately liquidated. Credit has other important aspects. Most enterprises ask for credit at banks, the object being to secure aid in bridging periods of financial stringency. In many lines of business, activity is seasonal in character, heavy purchases being made at certain periods to meet correspondingly heavy demands. At such times, banks step in to render the desired aid by granting short-term loans to merchants.

Credit is essential to modern business. A business man cannot expect to obtain credit unless he can present to the bank and investors financial statements which give a true picture of his debt-paying ability.

Credit takes many forms. It is sometimes long-term, as for example, where bonds are sold. In any event, financial statements must be made the basis of all credit arrangements and these financial statements cannot be secured unless an adequate system of accounts supplies the data necessary for their preparation.

Credit has its function in practically all fields. It is used in manufacturing, wholesaling, and retailing, as well as in such fields as government and various forms of public enterprise. In any event, credit must be based on statements made possible only through adequate accounting.

**Investments.** Although investing sometimes is regarded as one aspect of credit, it is of sufficient importance to deserve mention here. An investor is an individual or an institution which places his or its money in the hands of financial agencies. It is expected that the principal sum thereof will be preserved and that, in addition, there will be received on such principal sum a reasonable rate of income, usually in the form of interest. It is evident that the investor cannot act intelligently in placing his money unless he has the benefit of financial statements, sufficiently detailed and current to enable him to pass judgment on the financial status of the borrower. Even where the investor permits others to determine how his investments should be made, the same is true, since these intermediaries cannot advise clients without having adequate financial statements upon which to base their analyses and to render decisions.

Enterprises which fail to insist upon satisfactory accounting procedure cannot expect to establish good ratings with investors and financial agencies.

**Fields of Accounting.** The science of accounting may be divided into two fundamental divisions, namely: (1) constructive accounting, (2) analytical accounting.

The word *constructive* indicates what the character of constructive accounting is, namely, that it is concerned with the application of accounting principles to the planning of accounting systems. It is based on relatively simple principles, but the application of these principles makes necessary extensive variation in form and detail. Accounting systems, although based on principles which do not change, must meet the requirements of widely varying circum-

stances. Constructive accounting devises systems which will meet the requirements of the small retail store and the large manufacturing enterprise. It is in the field of constructive accounting that the accountant is required to exercise imagination and judgment in order that the system which he installs may correspond to the organization of the business.

The word *analytical* in accounting refers to a critical study of existing records, whereas, the accountant when doing constructive work installs and operates an accounting system. The accountant when doing analytical work examines and analyzes records already made. It is chiefly in the field of analytical accounting that professional public accountants operate. The professional auditor is one who by training and experience is especially well adapted to the work of examining, analyzing, and reporting upon accounting records.

Analytical accounting, or auditing, is of great importance because it tends to prevent manipulation of accounts, falsification, and embezzlement.

Although for certain purposes it may be desirable to divide the field of accountancy into constructive accounting and analytical accounting, it usually will be found that a somewhat different classification of the branches of accounting can be made. By the nature of the subject, the subdivision into branches applies chiefly to constructive accounting, since analytical accounting may be said to comprise mainly auditing. In the following paragraphs is given a brief description of the important branches of accounting.

**Special Branches of Accounting.** At this point, no attempt will be made to outline the principles which make up the subject matter of special branches of accounting. The student cannot expect to master these special fields until he has first mastered the basic principles of accounting. Nevertheless, it is possible to indicate what these special branches of accounting are and the function which each performs.

*1. Cost Accounting.* In a sense all accounting is cost accounting, but in a more technical sense cost accounting is a highly specialized branch of accounting which, although it is based on the same fundamental principles as are all other branches of accounting, has as its

function the determination not of total monthly or yearly costs, but of costs of individual units of output.

To illustrate, assume that a company is engaged in the manufacture of pianos, and that it produces twelve different styles of these instruments. One style is regarded as basic, the other styles are elaborations of the basic model. It is evident that there arises in this instance the problem of determining not only the cost to manufacture all pianos completed in a given period of time, but also the cost of a piano in any particular group of the twelve groups. If the pianos were the same in style, the cost per piano could be obtained by dividing total monthly or yearly costs of manufacture by the total number of pianos manufactured. This cannot be done, however, in the case of our illustration, and it usually will be found that a manufacturing enterprise produces a variety of output so that a cost of a given unit cannot be ascertained by simply dividing total costs by the total number of units produced.

Obviously there must be many variations even in the field of cost accounting because the conditions under which different types of articles are produced vary greatly. One type of cost accounting will be suitable for a laundry, another type for a blast furnace, and still another type will be required by a concern manufacturing shoes.

The student will do well to keep in mind the importance of the concept of cost accounting. The subject of costs is likely to become of increasing importance, because competition and the exhaustion of natural resources will tend to decrease margins of profit. Any enterprise which is unable to ascertain with reasonable accuracy its costs cannot be certain that it is making a profit. It may be possible and even desirable to sell certain goods below cost, but to pursue such a policy leads inevitably to insolvency.

In certain fields the ascertainment of cost is a relatively simple problem, while in other fields it is a highly complicated one. The individual who hopes to become an accountant will do well to secure as much information as possible concerning the principles which determine cost, and the methods whereby the elements of cost can be computed.

2. *Government Accounting*. Formerly the function of the government was assumed to be limited to the protection of its citizens and

all property through the operation of what was known as the police power. This *let alone* theory of government has long since been abandoned. Instead we now hear of *regimentation* and a great centralization of power in Washington. A surprisingly large percentage of our total population is employed by the federal and state governments and local governmental units. This activity on the part of government necessitates great expenditures of money. Those in charge of enterprises financed by the government must be able to account accurately for all receipts and disbursements of money. Frequently, government bonds mature only at the end of long intervals of time. Such organizations as post offices are concerned with the collection and disbursement of many millions of dollars.

Local units of government, such as counties and municipalities, also are involved in the collection and expenditure of large sums of money. Although developments in the field of government accounting cannot be said to have kept pace with those in the field of commercial accounting, much is being done at the present time to improve methods of government accounting. Undoubtedly in the future a large number of young men will secure employment as accountants with one or another of the many governmental units found in this country.

*3. Tax Accounting.* Closely related to government accounting is tax accounting, since governments depend upon taxes as their principal or only source of revenues. Our federal government and many of our state governments have enacted income tax legislation. A citizen of a state which imposes an income tax may therefore be required to pay both a federal and a state income tax. Income taxes are paid also by corporations and may be paid by estates. The history of the development of the income tax in the United States is closely allied with the history of the development of accountancy. To some extent this coordination between tax development and accounting development has been accidental, but in many respects it may be said that the development of accounting principles and terminology has been closely related to the development of the income tax. This is only natural since the computation of taxable income can be made only through the application of standardized and widely accepted accounting principles. Much of the work of

private and public accountants is related to the problem of income taxation. The Treasury Department of the United States, over a long period of years and with the cooperation of accountants and attorneys, has compiled a great amount of material which may be said to be an interpretation of accounting principles as they relate to taxation. In addition, the various boards, commissions, and courts have contributed their part to the discussion. The income tax division of the Treasury Department is in itself a large administrative body, having offices not only in Washington, but in other cities throughout the country.

Many young men looking forward to careers in accountancy may expect to be confronted with the problem of income taxation. Should they become specialists in this field, it would be necessary for them to understand not only the basic principles of accounting, but to know how to apply these principles in view of the provisions of the laws, regulations of the Treasury Department, and the rulings and decisions of the various administrative and interpreting bodies.

There can be little doubt that income tax problems will remain matters for serious consideration on the part of accountants. The student of accounting should, therefore, keep in mind that it may be necessary, on occasion, to relate his knowledge of accounting to laws and regulations imposing and administering the income tax.

*4. Managerial Accounting.* All accounting is in a sense managerial accounting, since accounting records are basic necessities to the manager. However, accounting may be considered with special emphasis on its uses to management. Management is concerned primarily with the formulation and carrying out of policies relating to such concrete matters as sales volume, inventory control, preservation of working capital, amortization of long-term debts, etc. Notwithstanding the element of judgment which must enter into successful management, much information can be derived through the analysis of financial statements which will provide the manager with a background of facts upon which to render his decisions. Rule-of-thumb methods of doing business must be displaced by methods which are based on facts in the form of ratios and other analyses.

Budgeting already has been mentioned. It is one of the important means whereby managers may to a large extent escape from what might be called the rule-of-thumb or hit-or-miss methods or plans of procedure.

Managers demand unusually detailed financial statements. Balance sheets and profit and loss statements required for internal management purposes may purposely contain many details not shown in the published reports of corporations. Moreover, these financial statements must be promptly prepared and at intervals sufficiently brief to enable the manager to enforce necessary remedial measures before excessive losses have been incurred. Some statements must be presented daily to the manager. Some may be presented to him at the end of each month. As a rule, annual statements are inadequate as a means of determining managerial policies because harmful trends cannot be changed in time to prevent serious consequences.

*5. Personal Accounting.* The importance of personal accounting is frequently underemphasized. By personal accounting is meant the keeping of accurate records of one's own income and expenses. Frequently, such accounts should be kept on a household basis. This is true, for example, in case of families. Individuals receiving sufficient income to be required to pay the income tax should keep personal accounting records as a matter of satisfaction and in order to prove sums reported to the income tax authorities.

Much personal accounting is inadequate in character, consisting of little more than check book records and miscellaneous memoranda. It usually will be found that, based on experience, a satisfactory analysis can be made both of items of income and items of expense. The information derived therefrom should be an aid to thrift and to the more satisfactory spending of one's money. Personal accounting records, as a rule, are not highly complicated, but they can be made to serve as a means for the intelligent analysis of income and expense.

Perhaps with the increasing appreciation of the importance of records, generally, more people will consult accountants as they now consult physicians, with a view to keeping their personal affairs in satisfactory condition. The ability to account for one's own in-

come and expenses ordinarily will more than repay one for the expense and labor of acquiring a working knowledge of accounting.

*6. Auditing.* Auditing is sometimes regarded as including all aspects of analytical accounting; however, certain kinds of analytical work may be done which are not considered as auditing. For instance, a division of the accounting department may be concerned with the computing of ratios and the preparing of various kinds of analytical statements. This is not necessarily auditing.

Auditing may be defined as the work of reviewing accounting records with a view to the location of errors and also with a view to the preparation of reports. It has been said that, on an average, the work of public accounting firms is 85 per cent auditing. At any rate, this figure is indicative of the importance of auditing. The methods pursued by professional auditors are reasonably well standardized; however, there is a tendency for public accounting firms to establish their own detailed accounting procedure. This is as it should be, since a firm's auditing procedure should reflect the results of its experience in the various fields of enterprise.

Much auditing is of a non-professional character. Some of this work is of a high standard. This is particularly true where large corporations employ their own auditors with a view to securing a more or less continuous check on the work of their accounting departments. Some auditing, however, is of a more or less superficial character. This is likely to be the case where persons unfamiliar with accounting are appointed to do occasional auditing work.

**Accounting and Law.** The student who hopes to secure the best results from his study of accounting must realize the extent to which accounting and law are related. The accountant is constantly confronted with questions, the answers to which depend, more or less, upon an understanding of law. This does not mean that an accountant, in order to be successful, must be a lawyer also. It does mean, however, that he must have a knowledge of the principles of law in so far as they relate to business, and it also means that he must be able to so appraise the situation that he will know when to consult a competent lawyer.

The examination for the Certified Public Accountant certificate covers business law, as well as subjects strictly accounting in char-

acter. An understanding of law, as it relates to the various branches of contracts, is indispensable. It will be found that the law of contract lies at the basis of the various divisions of commercial law. For example, such subjects as agency, sales, insurance, and many others are simply special divisions of the law of contracts.

Questions of law are certain to arise in connection with the routine work of the accountant. For example, the accountant is confronted with the question as to whether or not a purchase of merchandise in transit at the end of the year should be entered on the books or be permitted to wait and be entered on the books in the following period, after the goods are received. His decision will probably depend upon the answer to the question, "Has title to the goods passed to the buyer?" If upon investigation of the situation, in the light of legal precedent, the accountant determines that title has passed to the buyer of the goods, he will make an entry as at December 31 for the purchase of the goods. If he decides that title has not passed to the buyer, he will not make the entry.

To illustrate again, suppose that a question arises as to the rate of depreciation to be applied to a patent owned. It is evident that the accountant must be familiar with patent laws in the United States in order to intelligently answer this question.

**Accounting and Engineering.** The relation of accounting to engineering is one of importance because of the physical aspects of problems which frequently confront the accountant. The engineer is expert in questions relating to the physical condition of the plant and equipment. Since the accountant must determine depreciation rates and must pass judgment frequently on matters involving appraisals, he must be able to recognize the engineering features of the problems which arise in his domain. The situation is similar to the one which he assumes in relation to legal problems. He must be sufficiently familiar with engineering to know when to ask for the aid of an engineer.

Some accounting firms specialize in fields necessitating the employment of engineers on their staffs. Some industrial engineering firms perform work which necessitates also the services of accountants. This interrelation between accounting and engineering has become a matter of first rate importance because of the

great growth in commercialism necessitating heavy investments in plant and equipment of various kinds. The accountant will do well to try to understand wherein his work may be related to the work of the engineer.

**Future of Accountancy.** The purpose of this chapter has been to indicate the nature of the importance of accounting. To one beginning the study of accounting the question naturally arises, "What is the future of the accounting profession and what are the opportunities available to one who has studied accounting sufficiently to master its principles?" Accounting is generally regarded as the newest of the professions. Its development in the United States has been limited to a period of about 50 or 60 years. Today there are several magazines and many books available dealing with one aspect or another of the subject. There are, perhaps, eight or ten thousand persons engaged in the public practice of accounting, while many more than that number are occupied in private accounting work for corporations and other forms of organization. A considerable number of accountants today find employment in one branch or another of government service. Statistics indicate that members of the accounting profession are paid at least as well as are the members of the older professions of law, medicine, and engineering.

One who possesses an aptitude for accounting work, and who enjoys the making of analyses and the preparation of statements, and who at the same time is able to carry on work involving masses of detail, may regard himself as temperamentally fitted for accounting work. Perhaps the best-paid positions are those found in private employment, but there are undoubtedly offsetting advantages in the field of public accounting. The young man or young woman ambitious to become an accountant will do well to consider the opportunities which are offered. There exists considerable literature dealing with the nature of professional, private, and public accounting work in the form of books and magazine articles. The student having access to these will be able to secure a better understanding of the possibilities in the field of accounting endeavor.

# *Chapter* 2

# THE BALANCE SHEET

**Financial Position.** It is common business custom to speak of the financial position or financial status of an enterprise. To the layman, financial position may mean little, but to the person familiar with accounting principles it means much, because financial position is determined by many facts which must be presented in significant form and arrangement.

It is evident that one engaging in business must own certain property and he usually owes certain debts. In other words he has assets and liabilities. Fundamentally, financial position is the result of the situation briefly explained above.

To illustrate, suppose that John Brown is engaged in the retail grocery business, that his total assets amount to $100,000.00 and that his total debts amount to $40,000.00. It is evident that Brown's net interest in his business is the excess of his assets, $100,000.00, over his debts, $40,000.00. This amounts to $60,000.00. Now, applying the language of accountants to Brown's status, it may be said that he has assets of $100,000.00, liabilities of $40,000.00, and a net worth, or proprietorship, of $60,000.00. These facts may be expressed in technical form as shown in the Balance Sheet in Fig. 1.

**John Brown**

BALANCE SHEET

| | | | |
|---|---|---|---|
| Assets. | $100,000.00 | Debts.................. | $ 40,000.00 |
| | | J. Brown, Net Worth.... | 60,000.00 |
| | $100,000.00 | | $100,000.00 |

Fig. 1

It is evident that this balance sheet indicates Brown's financial position, as at some given date. If we assume that this is his financial

position at the close of business on December 31, 19—, the balance sheet may be revised as shown in Fig. 2.

**John Brown**

BALANCE SHEET
**as at December 31, 19—**

| | | | |
|---|---|---|---|
| Assets . . . . . . . . . . . . . . | $100,000.00 | Debts . . . . | $ 40,000.00 |
| | | J. Brown, Net Worth | 60,000 00 |
| | $100,000.00 | | $100,000.00 |

Fig. 2

It is evident that Brown's financial position will not remain as indicated in Fig. 2. He will purchase additional merchandise and make sales. Assume that his income for the following year amounts to $10,000.00 in excess of all costs and expenses. It is evident that he will make a profit of that amount, namely, $10,000.00. This means that his assets will be increased $10,000.00 and, assuming that his debts remain at $40,000.00, his net worth likewise will be increased $10,000.00, so that his balance sheet as at December 31, 19— will appear as shown in Fig. 3.

**John Brown**

BALANCE SHEET
**as at December 31, 19**

| | | | |
|---|---|---|---|
| Assets . . . . . . . . . . . . . | $110,000.00 | Debts . . . | $ 40,000.00 |
| | | J. Brown, Net Worth . | 70,000.00 |
| | $110,000.00 | | $110,000.00 |

Fig. 3

**Accounting Period.** An interval of one year was assumed between balance sheets in Figs. 1 and 2. Accountants refer to this interval between balance sheets as the accounting period. The accounting period may be one year, as in the illustration above, or it may be one month, as is not infrequently the case in modern business. It is essential that accounting periods of uniform length be followed, otherwise the statements resulting cannot be said to be on a comparative basis.

**Need of Greater Detail.** The illustrations given above are purposely brief in order that the main outline of the principles may be grasped by the student. It is evident, however, that much more detail must be explained in balance sheets if the financial position of a business is to be given proper explanation. To say that Brown's assets equal $100,000.00 or $110,000.00 gives insufficient information for the reader of Brown's balance sheet to enable him to determine whether Brown has distributed wisely this amount among the various kinds of assets needed to carry on the retail grocery business. At this point, it may be explained that an asset is anything of value owned by an enterprise and which, with a few possible exceptions, is used in carrying out business operations.

It also is evident that more information will be needed relative to Brown's debts. Debts incurred in the purchase of merchandise must usually be paid within a relatively short period of time. On the other hand, mortgages may not mature until a period of years has expired. Before a business man can understand his financial position, he must have a classification of both assets and debts which will enable him to determine whether assets will be available for the liquidation of debts as they mature.

As regards net worth, the need for great detail in the case of Brown's balance sheet is not so evident. Of course, Brown should be able always to distinguish that which he has added to his net worth in the form of profit from that which he originally invested. In the case of the sole proprietorship, the information relative to net worth usually can be expressed in the balance sheet as a single item. As will be explained later, this amount can be analyzed to show what portion is original investment and what portion is accumulated profit.

**Meaning of Classification.** The foregoing considerations make it desirable to explain at this point the significance of the word *classification.* It is customary to speak of the classification of assets and the classification of debts. In some instances net worth is also subject to greater or less classification.

In general, the word classification means the division of a group of things into two or more subgroups, each subgroup possessing certain characteristics which distinguish it from the other sub-

groups. Each subgroup may be further classified. The idea of classification may be illustrated as follows: If A represents the total group, then 1, 2, 3, etc., may be permitted to represent subgroups. Each subgroup may in turn be classified *a*, *b*, *c*, etc. If these are subject to further classification, the numerals (1), (2), (3), etc., may be used to indicate the proper items. A still further classification might be indicated by (*a*), (*b*), (*c*), etc. This procedure whereby each successive subclassification represents a delimitation is illustrated in Fig. 4.

A.
1.
2.
3., etc.
*a*)
*b*)
*c*), etc.
(1)
(2)
(3), etc.
(*a*)
(*b*)
(*c*), etc.

Fig. 4

Using assets to illustrate further the principles of classification, the outline classification shown above may be filled out as shown in Fig. 5.

A. Assets
1. Current
*a*) Cash
(1) In bank
(*a*) First National
(*b*) City National
(2) On Hand

Fig. 5

The importance of a correct application of the principles of classification will become clearer as the student progresses in his study of accounts. It may be stated here that the correct classification of all items is a long step toward success in business.

**Asset Classification.** Accountants are not entirely agreed as to what is the most desirable fundamental classification of assets.

Moreover, classifications of assets should not be the same in different lines of business. Obviously, the assets of a bank are not subject to the same classification as are the assets of a manufacturing concern. The illustration which follows must therefore be looked upon as merely suggestive and subject to modification and elaboration when applied to a particular business. In order to secure a basis of discussion of assets, the classification shown in Fig. 6 will be used.

A. Assets
1. Current
2. Fixed
3. Investments
4. Intangible
5. Deferred

Fig. 6

**Current Assets.** Current assets may be defined as cash and other items which, in the normal course of business, may be converted into cash. Merchandise is an illustration. Merchandise is purchased to be sold as soon as possible. It may be sold for cash, or on account. If sold for cash, it is immediately converted into cash. If sold on account, it is converted into cash when the customer pays his account. Accounts receivable, as the foregoing statement indicates, represent a step in the process of realizing cash on merchandise sold. Accounts receivable are therefore current assets. Sometimes merchandise is sold and notes or acceptances taken in payment. These also are current assets since they will be converted into cash when paid. Sometimes cash is temporarily invested in bonds which can be liquidated easily when more cash is needed. It is correct, therefore, to regard certain short-term investments as current assets, because in the normal course of business they will soon be converted into cash.

It may be seen, therefore, that current assets follow a circular movement. Beginning with cash there follows merchandise purchased, next, accounts, or notes receivable, and finally again, cash. This is perhaps the explanation for the rather common use of the term *circulating assets*. Although this is a significant expression it is not used in the classifications found in this book. In Fig. 7 is shown a classification of current assets which is intended to be merely sug-

gestive of the nature of this important group of assets. It will, of course, require revision for particular enterprises.

A. Assets
  1. Current
    *a*) Cash
      (1) In Bank
      (2) On Hand
    *b*) Merchandise
    *c*) Accounts Receivable
    *d*) Notes Receivable
    *e*) Acceptances Receivable
    *f*) Temporary Investments

Fig. 7

*1. Cash.* Cash consists of money on hand and in the bank. Its distinctive characteristic is its availability for making all kinds of payments. It is, in other words, a medium of exchange. Cash is a useful asset only in so far as it is needed for making payments. An excessive amount of cash is idle wealth. By the cash position of an enterprise is meant the amount of cash it possesses when considered in relation to the uses it will be required to make of such cash. Thus, the cash position is strong if an abundance of cash is available to meet all requirements, whereas, the cash position is weak if the amount of cash available to meet requirements is small.

Sometimes items of doubtful validity are carried as cash, such as I.O.U.'s from officers and employees. Checks available for immediate deposit are properly considered as cash.

There are various methods of handling cash on hand, and it is necessary that it be handled correctly. Unless all cash receipts are deposited in the bank, confusion in the handling of cash is likely to result. Cash to be used in making current disbursements, which cannot be made by check, should be kept in a separate fund which can be replenished periodically.

*2. Merchandise.* By merchandise is meant goods purchased to be resold, usually at a profit. In case of manufacturers, raw materials are purchased to be reworked before being sold; as a consequence, in place of merchandise, manufacturers have three inventories, namely: (a) raw materials, (b) goods in process, (c) finished goods.

Inventories are necessary and important. To achieve the greatest success in business, inventories must be disposed of and replaced at a reasonably rapid rate. This is technically known as inventory turnover. Inventory of merchandise must not be permitted to accumulate to such an extent as to tie up capital unnecessarily. The same is true of inventories of raw materials and finished goods. The accounting procedure required in connection with merchandise and also with the inventories of raw materials, goods in process, and finished goods is an important one.

*3. Accounts Receivable.* Accounts receivable are the debts which are owed to the business for merchandise sold. This item is of importance because it is the source of great loss if uncollectible accounts receivable are permitted to accumulate. Accounts receivable should be cleared out many times each year except in those lines of business where slow payments are recognized as proper. Accounts receivable must be analyzed periodically for the purpose of locating past due items. It is inevitable that some losses will occur in the form of uncollectible accounts receivable, but these can be reduced to a minimum by avoiding undesirable customers and by taking prompt measures to collect.

A considerable amount of capital is tied up frequently in accounts receivable. This is necessarily the case where credit is extended to customers. Continuous attention, however, should be given to the matter to avoid any undesirable increase in the amount of capital so used.

*4. Notes Receivable.* Notes receivable sometimes perform much the same function as do accounts receivable, that is, where notes are customarily accepted from customers. Where this is the case, they should be given much the same consideration as are accounts receivable. Notes receivable indicate more definitely the customers' liability and can be discounted usually at banks, whereas accounts receivable can be discounted only with certain classes of finance companies, and usually only at relatively high rates of discount.

Where notes have been accepted from customers unable to pay on open account promptly, they may be a doubtful asset. Much in the way of legal precedent has been established in connection with notes. This has been incorporated in the Uniform Negotiable In-

struments Law, which has been enacted in all of the states, thus effecting uniform procedure.

A note is defined in the Uniform Negotiable Instruments Law as "an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money, to order or to bearer."

*5. Acceptances Receivable.* Acceptances receivable are treated in much the same manner as are notes receivable, but differ from notes receivable in that they contain on their face the statement that "The obligation of the acceptor hereof arises out of the purchase of goods from the drawer. The drawee may accept this payable at any bank, banker, or trust company in the United States which he may designate."

Acceptances are one form of bills of exchange and are defined by the Federal Reserve Board as "Bills of exchange drawn by the seller on the purchaser of goods sold, and accepted by such purchaser." Acceptances receivable are an especially desirable form of asset because of the ease with which they can be discounted and rediscounted.

*6. Temporary Investments.* Temporary investments may be made in whatever securities are suitable, or they may take the form of certificates of deposit in banks upon which a low rate of interest is earned. They are properly classified as current assets because they represent merely the investment of cash during periods when more cash is available than is needed and will be converted back into cash when occasion demands.

**Fixed Assets.** Fixed assets are in clear contrast with current assets because they are not to be sold, but are to be used and, as a rule, worn out in the business. Fixed assets require much attention from the accountant because of the heavy capital investment usually required therein, and because of the need of taking necessary steps for the preservation of this investment. Whereas an over-investment in merchandise usually can be remedied in a short period of time, an over-investment in fixed assets is, on the other hand, a more or less permanent drag on the business, for the reason that fixed assets usually can be disposed of only at heavy losses.

The distinction made above between current assets and fixed assets is true only relatively, for whereas current assets are being sold and renewed constantly, thus being converted into cash, fixed assets are also being renewed constantly and therefore, over long periods of time, pass into the cash stage. In a sense, too, fixed assets are sold, but only indirectly, being charged to customers in the form of depreciation, which is one kind of expense. Therefore, to summarize, it may be said that whereas current assets are renewed frequently many times each year, fixed assets are usually renewed only at long intervals of time, sometimes as long as 20, 30, 40, or 50 years. In Fig. 8 is presented a suggestive classification of fixed assets. This, of course, is subject to revision for purposes of particular enterprises.

A. Assets
- 1. Fixed
  - *a*) Land
  - *b*) Buildings
  - *c*) Machinery
  - *d*) Furniture and Fixtures
  - *e*) Delivery Equipment

Fig. 8

*1. Land.* Land is usually said not to depreciate, although there are exceptions to this rule. Land is perhaps the most fixed of all assets and may be regarded usually as being indestructible. Depreciation, as it applies to land, means exhaustion of fertility or decline in value resulting from such unfavorable influences as changing laws and shifting populations. The accountant should segregate land from buildings and other fixed assets because of its peculiar characteristics. Frequently, land and buildings are indicated as one asset. This is not good procedure. Land may be subclassified in accordance with the uses to which it is put, such as land used in operations and land held for investment purposes. Varying circumstances may require other classifications of this important asset.

*2. Buildings.* Sometimes heavy investments are required in buildings. This is particularly true in case of manufacturers. Buildings are of various types and uses and when properly accounted for are classified in accordance with their type and use. The investment

in buildings represents a sum which must be preserved notwithstanding that buildings depreciate more or less rapidly. The accounting procedure necessary to accomplish this preservation of the investment will be considered later.

*3. Machinery.* Machinery sometimes represents a large investment. This investment must be preserved, as in case of buildings. The expiration of this investment is known as depreciation. The principles which should govern the treatment of this investment will be considered later. In some instances, the amount of capital invested in machinery is sufficient to make the treatment of depreciation thereof a problem of primary importance.

*4. Furniture and Fixtures.* This item includes such assets as chairs, tables, adding machines, and show cases. Little uniformity of opinion exists even among accountants as to the correct accounting treatment for furniture and fixtures. As a rule, the rate of depreciation is high and, of course, it is necessary to make adequate provision therefor in the records.

*5. Delivery Equipment.* This item includes trucks, wagons, etc., used in delivering merchandise sold to customers. Depreciation thereon is high and must be accounted for. In some retail establishments, the investment in delivery equipment is a material one and the cost of upkeep may be considerable.

**Investments.** For present purposes, it is unnecessary to attempt any classification of investments. The item does not appear on many balance sheets. When it does appear, it indicates a non-operating asset. Such investments may be established for various purposes, such as a fund for the construction of a building at some future date. Sometimes investments represent an interest in allied enterprises. At this point, it is sufficient to note that investments are a distinct item in the balance sheet because they indicate funds not being used for operating purposes.

**Intangibles.** An intangible asset is one which does not possess physical properties and therefore is not of a nature to permit measuring and weighing. Examples of intangible assets are goodwill, patents, copyrights, trademarks, and franchises. It is essential that intangible assets be segregated carefully from other assets in the balance sheet because they depreciate in accordance with rather

definite principles and because investors and bankers always prefer to see this item set out in contrast with other items in the balance sheet.

**Deferred Assets.** Deferred assets are expenses paid in advance, such as prepaid insurance, prepaid advertising, and prepaid rent. Some deferred items depreciate in accordance with definite contractual arrangements; in other instances the depreciation must be estimated. An illustration of the first type is prepaid insurance which may be prepaid for, say, three or five years, and therefore its value disappears over a three- or five-year period, proportionately to the expiration of time. In the case of prepaid advertising, no such definite basis for determining depreciation is present; therefore it is necessary to estimate how long the benefits will continue.

**Liability Classification.** Accountants are fairly well agreed as to the fundamental classification of liabilities into current and fixed. Sometimes other items, such as liability reserves, are included, but for the present the subdivision of liabilities into current and fixed will be followed, as shown in Fig. 9.

L. Liabilities
1. Current
2. Fixed

Fig. 9

**Current Liabilities.** Current liabilities are usually regarded as obligations which will fall due and become payable within a period of one year or less. This is a somewhat arbitrary limitation but quite suitable for practical purposes. In the outline shown in Fig. 10 are listed current liabilities which commonly occur in business. This outline is not intended to be all inclusive, but is subject to revision for the purposes of particular enterprises.

L. Liabilities
1. Current
    *a*) Accounts Payable
    *b*) Notes Payable
    *c*) Dividends Payable
    *d*) Accrued Taxes

Fig. 10

*1. Accounts Payable.* Accounts payable are debts incurred in the purchase of merchandise or raw materials. Accounts payable which originate in any other way should be segregated and shown separately. As a rule, accounts payable must be paid within from 30 to 60 days, or sooner if cash discounts are offered. For example, it is certain that the terms for a particular purchase are 2 per cent 10 days, net 30 days. This means that 2 per cent may be deducted if payment is made within 10 days from date of invoice, but that if the discount paid is allowed to pass, payment must be made within 30 days from date of invoice.

*2. Notes Payable.* In some lines of business, the vendor* asks the vendee to sign a note for the amount of the purchase. This may be because it is the custom in that particular line of business. Notes are discounted more readily, as has been explained. They may bear interest from date or they may bear interest from maturity only if not paid at maturity. Acceptances payable may, for the present, be classified with notes payable, since from the point of view of the acceptor they fulfill the same function as do notes payable.

*3. Dividends Payable.* This item appears only in the balance sheet of corporations. It represents the liability of the corporation to stockholders for the amount of the dividend declared by the corporation's board of directors. For example, if the corporation has outstanding $100,000.00 of capital stock and declares a dividend of 5 per cent, an item entitled *Dividends Payable, $5,000.00* will appear in the current liability division of the balance sheet. This may be paid in one payment, but usually dividends are made payable quarterly; thus, in the case of the illustration, the first payment would be $1,250.00, which should reduce the amount of the dividends payable to $3,750.00. This liability would, in turn, be reduced by the three quarterly payments to follow.

*4. Accrued Taxes.* Taxes for a given year usually become due and payable in the following year. Since the amount varies from year to year, and since the bill for a particular year is not received until after the close of that year, it is necessary to estimate the amount of taxes accrued. This is shown as a current liability and, of course, is subject to adjustment when the exact amount of the taxes becomes known.

*A *vendor* is a seller, a *vendee* is a buyer.

**Fixed Liabilities.** Fixed liabilities are those which fall due and become payable within a period of more than one year. In Fig. 11 fixed liabilities are outlined briefly. This outline is only suggestive. For example, a corporation might have outstanding several bond issues.

L. Liabilities
  2. Fixed
    *a*) Mortgages Payable
    *b*) Bonds Payable

Fig. 11

*1. Mortgages Payable.* In case of sole proprietorship and partnership, long-term loans usually are secured by a mortgage on fixed assets. The liability usually is known as a *Mortgage Payable*, and should be listed as a fixed asset in the balance sheet.

*2. Bonds Payable.* Corporations usually borrow for long-term periods by selling bonds. There are many types of bonds but these need not be described at this point. If there is a single issue of bonds outstanding, it will be designated by indicating briefly the nature of these bonds; thus a corporation might have outstanding $500,000.00 of second mortgage 7 per cent bonds. These bonds outstanding should be listed in the balance sheet under *fixed liabilities*.

**Net Worth.** As has been explained, net worth is the excess of current assets over current liabilities. It also has been shown that in case of a sole proprietorship this is known by some such name as *J. Brown, Net Worth.* It is necessary, however, that an understanding be secured of the way in which net worth is shown in case of partnerships and corporations. In Figs. 12, 13, and 14 are outlined the net worth divisions of the balance sheet for sole proprietorship, partnership, and corporation, respectively.

N. Net Worth
  1. Sole Proprietorship
    *a*) Capital Account

Fig. 12

N. Net Worth
  1. Partnership
    *a*) Capital Accounts
    *b*) Drawings Accounts

Fig. 13

N. Net Worth
   1. Corporations
      *a*) Capital Stock
         (1) Common
         (2) Preferred
      *b*) Surplus
         (1) Earned
         (2) Capital

Fig. 14

**Net Worth—Sole Proprietorship.** As indicated in Fig. 12, the net worth of a sole proprietorship is set forth in a single Capital account. To this is adjoined the proprietor's name so that in the balance sheet the title of the account reads, *J. Brown, Net Worth,* or *J. Brown, Proprietorship,* or *J. Brown, Capital Account.*

**Net Worth—Partnership.** In case of a partnership, each partner has a separate Capital account and a separate Drawings account, so that there are as many capital accounts and drawings accounts as there are partners. As will be explained later, however, only the partners' capital accounts are shown in the balance sheet. The drawings accounts are not so shown.

**Net Worth—Corporation.** As has been stated, the net worth section of the balance sheet of a corporation is distinctive because in a corporation net worth or ownership is expressed in the form of shares of capital stock. If, for example, one owns 10 shares out of a total of 1,000 shares of stock outstanding, he owns 1/100 of the corporation. Since the capital stock is still shown in the balance sheet for which it was issued, profits cannot be credited to the Capital Stock account in the way they are credited to the Capital account of the sole proprietor and to the capital accounts of partners. In a corporation accumulated profits are shown in a Surplus account. As indicated in Fig. 14, capital stock may be either common or preferred, and surplus may be either earned or capital surplus. It is unnecessary at this point to explain the full significance of common stock as distinguished from preferred stock, and to explain in detail the difference between earned and capital surplus. In brief, however, it may be stated that preferred stock is stock which is given a preference usually as to dividends; that is, a dividend of an expressed per cent or amount must be paid on the

preferred stock before any dividend can be paid on the common stock. Also it may be stated that earned surplus represents profit derived from operation, whereas capital surplus represents an increase in net worth, derived from some such source as the sale of capital stock at a premium, donations, and revaluation of fixed assets.

**How Balance Sheet Data Is Secured.** The preceding pages consist of an elaboration of the first paragraph, whch was entitled *Financial Position*. The financial position is expressed in the balance sheet and is an indication of a condition as at a given date only. This balance sheet approach to the study of accounting has been selected because the student thus learns to appreciate that the one main purpose of accounting is to show financial position at given intervals of time. Another main purpose of accounting is to explain changes which occur between balance sheet dates. This idea will be elaborated upon later. For the present, it may be stated that the data used to construct a balance sheet must be taken from the best available records. It is the purpose of accounting to provide records which will give complete balance sheet data. How this is done is the subject matter of this book. It is necessary therefore for the student to study first financial position by means of assumed balance sheet data, and then later he will be in a position to understand how this data is actually secured in practice.

**Illustrative Balance Sheets.** In Figs. 1 and 2 simple forms of the balance sheet are shown. Based upon the study of balance sheet classification of assets, liabilities, and net worth it is now possible to elaborate upon the form of the balance sheet and to give fairly detailed forms for the sole proprietorship, the partnership, and the corporation. See Figs. 15, 16, and 17.

**Comments on the Balance Sheets.** The data contained in the three illustrative balance sheets shown in Figs. 15, 16, and 17 have been varied only in so far as is necessary to show the difference between sole proprietorship, partnership, and corporation balance sheets. The student will note that the essential difference is in the net worth division; no other changes are shown. It may be stated, however, that in the balance sheet of a corporation bonds payable usually take the place of a mortgage. This is not necessarily the case, however, where the loan is as small in amount as $20,000.00.

### 1. Sole Proprietorship

**_John Brown_**

BALANCE SHEET

**as at December 31, 19—**

| | | | |
|---|---|---|---|
| Current Assets: | | | Current Liabilities: |
| Cash in Bank | $13,000.00 | | Accounts Payable |
| Cash on Hand | 400.00 | | Notes Payable |
| Merchandise | 10,000.00 | | Taxes Accrued |
| Accounts Receivable | 2,000.00 | | |
| Temporary Investments | 2,000.00 | | |
| | | $ 27,400.00 | Fixed Liability: |
| | | | Mortgage |
| Fixed Assets: | | | |
| Land | $13,000.00 | | Net Worth: |
| Buildings | 33,000.00 | | John Brown, Capital |
| Furniture and Fixtures | 10,000.00 | | |
| Delivery Equipment | 6,300.00 | | |
| | | 62,300.00 | |
| Investments | | 4,000.00 | |
| Intangibles: | | | |
| Goodwill | | 1,000.00 | |
| Deferred Assets: | | | |
| Prepaid Insurance | | 2,300.00 | |
| Prepaid Advertising | | 3,000.00 | |
| | | $100,000.00 | |

Fig. 15

### 2. Partnership

**Brown and Jones**

BALANCE SHEET

**as at December 31, 19—**

| | | | |
|---|---|---|---|
| Current Assets: | | | Current Liabilities: |
| Cash in Bank | $13,000.00 | | Accounts Payable |
| Cash on Hand | 400.00 | | Notes Payable |
| Merchandise | 10,000.00 | | Taxes Accrued |
| Accounts Receivable | 2,000.00 | | |
| Temporary Investments | 2,000.00 | | |
| | | $ 27,400.00 | Fixed Liabilities: |
| | | | Mortgage |
| Fixed Assets: | | | |
| Land | $13,000.00 | | Net Worth: |
| Buildings | 33,000.00 | | John Brown, Capital |
| Furniture and Fixtures | 10,000.00 | | Arthur Jones, Capital |
| Delivery Equipment | 6,300.00 | | |
| | | 62,300.00 | |
| Investments | | 4,000.00 | |
| Intangibles: | | | |
| Goodwill | | 1,000.00 | |
| Deferred Assets: | | | |
| Prepaid Insurance | | 2,300.00 | |
| Prepaid Advertising | | 3,000.00 | |
| | | $100,000.00 | |

Fig. 16

| | | |
|---|---|---|
| . . | $10,000.00 | |
| . . | 9,000.00 | |
| . . . | 1,000.00 | |
| | | $ 20,000.00 |
| . . . | | 20,000.00 |
| . . . | | 60,000.00 |
| | | $100,000.00 |

| | | |
|---|---|---|
| . . | $10,000.00 | |
| . . | 9,000.00 | |
| . . | 1,000.00 | |
| | | $ 20,000.00 |
| . . | | 20,000.00 |
| . . | | 40,000.00 |
| . . | | 20,000.00 |
| | | $100,000.00 |

**3. Corporation**

**Brown-Jones Company**

BALANCE SHEET

**as at December 31, 19—**

| | | | | | |
|---|---|---|---|---|---|
| Current Assets: | | | Current Liabilities: | | |
| Cash in Bank | $13,000.00 | | Accounts Payable | $10,000.00 | |
| Cash on Hand | 400.00 | | Notes Payable | 9,000.00 | |
| Merchandise | 10,000.00 | | Taxes Accrued | 1,000.00 | |
| *Accounts Receivable* | 2,000.00 | | | | $ 20,000.00 |
| Temporary Investments | 2,000.00 | | | | |
| | | $ 27,400.00 | Fixed Liabilities: | | |
| | | | Mortgage | | 20,000.00 |
| Fixed Assets: | | | | | |
| Land | $13,000.00 | | Net Worth: | | |
| Buildings | 33,000.00 | | Capital Stock | | 50,000.00 |
| Furniture and Fixtures | 10 000.00 | | Surplus | | 10,000.00 |
| Delivery Equipment | 6,300.00 | | | | |
| | | 62,300.00 | | | |
| Investments | | 4,000.00 | | | |
| Intangibles: | | | | | |
| Goodwill | | 1,000.00 | | | |
| Deferred Assets: | | | | | |
| Prepaid Insurance | | 2,300.00 | | | |
| Prepaid Advertising | | 3,000.00 | | | |
| | | $100,000.00 | | | $100,000.00 |

Fig. 17

The balance sheets shown are in what is known as account form, that is, the assets are placed on the left-hand side and the liabilities and net worth are placed on the right-hand side. Frequently, however, what is known as the statement form of the balance sheet is used. In order that the student may become familiar with the statement form, the corporation balance sheet in Fig. 17 is rearranged in statement form in Fig. 18.

**Brown-Jones Company**

BALANCE SHEET

**as at December 31, 19—**

| | | |
|---|---|---|
| **Assets** | | |
| Current Assets: | | |
| Cash in Bank | $13,000.00 | |
| Cash on Hand | 400.00 | |
| Merchandise | 10,000.00 | |
| Accounts Receivable | 2,000.00 | |
| Temporary Investments | 2,000.00 | |
| | | $ 27,400.00 |
| Fixed Assets: | | |
| Land | $13,000.00 | |
| Buildings | 33,000.00 | |
| Furniture and Fixtures | 10,000.00 | |
| Delivery Equipment | 6,300.00 | |
| | | 62,300.00 |
| Investments | | 4,000.00 |
| Intangibles: | | |
| Goodwill | | 1,000.00 |
| Deferred Assets: | | |
| Prepaid Insurance | | 2,300.00 |
| Prepaid Advertising | | 3,000.00 |
| | | $100,000.00 |
| **Liabilities and Net Worth** | | |
| Current Liabilities: | | |
| Accounts Payable | $10,000.00 | |
| Notes Payable | 9,000.00 | |
| Taxes Accrued | 1,000.00 | |
| | | $ 20,000.00 |
| Fixed Liabilities: | | |
| Mortgage | | 20,000.00 |
| Net Worth: | | |
| Capital Stock | | 50,000.00 |
| Surplus | | 10,000.00 |
| | | $100,000.00 |

Fig. 18

# *Chapter* 3

# PROFIT AND LOSS STATEMENT

**Financial Transactions and Accounting Period.** The manner in which the financial position may be shown has been explained. It also has been explained that it is customary to require a balance sheet at the end of certain intervals of time. In practice, the interval is usually either a month or a year. During this interval, or accounting period, changes occur, otherwise a business would remain stationary which obviously is inconceivable. The purpose of every business enterprise is to make a profit by selling goods or services and thus to fulfill a need in the community. It is evident that during even as short a period as one month hundreds or thousands of transactions will be consummated.

These transactions vary greatly in detail, but in general it may be said that they consist in transactions preparatory in character and transactions final in character. It is possible that several preparatory transactions may be carried out in order that one final transaction may result. To illustrate, among preparatory transactions are the purchase of merchandise, the hiring of clerical help, the insuring of property, and the advertising of merchandise or services. These preliminary transactions should result in sales which may be regarded as the final stage in the series. It is true, of course, that if sales are made on account it remains to collect the amount from the purchaser.

It may be said that these transactions have negative and positive results. The results of purchases of merchandise, paying of rent, paying for insurance and paying for clerical help, are, in themselves, negative in their effect on net worth, that is, they reduce net worth. On the other hand, sales are positive in effect and in a successful business they more than offset the negative factors. In other words, the net result of business transactions should be positive in character and should result in an increase in net worth. In an enterprise in

which the negative or expense factors outweigh the positive or income factors, net worth continues to grow smaller until insolvency occurs, that is, until net worth disappears and liabilities exceed assets. The purpose of accounting is to enable business men to avoid unfavorable trends by affording the information necessary for the elimination of unnecessary factors of expense and unprofitable sales. In order to determine approximately the results of financial transactions sufficiently soon to avoid unfavorable trends, it is necessary to adopt an accounting period sufficiently short in duration to make it possible to put into effect remedial measures before too much damage is done. For this reason the month is regarded as the proper accounting period in many businesses. It is evident that there are certain difficulties in thus arbitrarily summarizing results, because business is continuous in character and there is no particular date when all transactions may be concluded and an entirely new start taken. Notwithstanding, it is necessary to make whatever adjustments may be needed to give a reasonably accurate picture of results accomplished during the accounting period and to prepare those statements which are necessary to reflect not only the condition at the end of the period, but the changes which have occurred during the period. As has been explained, the condition at the end of the period is reflected in the balance sheet. The purpose of this chapter is to show how changes during the period are indicated in the profit and loss statement.

**Comparative Balance Sheet.** Since the balance sheet is used to show the financial condition of an enterprise at the end of each accounting period, it is evident that by placing two successive balance sheets in such arrangement the items thereon can be compared readily, and certain valuable conclusions can be drawn relative to the changes which have occurred in the financial position of an enterprise during the accounting period. This is done by setting up what is known as a comparative balance sheet. Usually two balance sheets are thus compared, although it is possible to show three or more balance sheets on a comparative balance sheet statement. In Fig. 19, a comparative balance sheet for John Brown is shown. In this case the accounting period is one month.

An examination of this comparative balance sheet indicates that

**John Brown**

COMPARATIVE BALANCE SHEET

**December 31, 19–6 and January 31, 19–7**

| | Dec. 31, 19–6 | Jan. 31, 19–7 | | Dec. 31, 19–6 | Jan 31, 19–7 |
|---|---|---|---|---|---|
| Cu rent Assets: | | | Current Liabilities: | | |
| Cash in Bank | $ 13,000.00 | $13,300.00 | Accounts Payable | $ 10,000.00 | $ 5,975.00 |
| Cash on Hand | 400.00 | 450.00 | Notes Payable | 9,000.00 | 8,750.00 |
| Merchandise | 10,000.00 | 11,000.00 | Taxes Accrued | 1,000.00 | 100 00 |
| Accounts Receivable | 2,000.00 | 700.00 | | $ 20,000.00 | $14,825 00 |
| Temporary Investments | 2,000.00 | 1,750.00 | | | |
| | $ 27,400.00 | $27,200.00 | Fixed Liability: | | |
| | | | Mortgage | 20,000.00 | 20,000.00 |
| :d Assets: | | | | | |
| Land | $ 13,000.00 | $13,000.00 | Net Worth: | | |
| Buildings | 33,000.00 | 33,000.00 | John Brown, Capital | 60,000.00 | 64,050.00 |
| Furniture and Fixtures | 10,000.00 | 9,950.00 | | | |
| Delivery Equipment | 6,300.00 | 5,975.00 | | | |
| | $ 62,300.00 | $61,925.00 | | | |
| Investments | $ 4,000.00 | $ 4,000.00 | | | |
| Intangibles: | | | | | |
| Goodwill | 1,000.00 | 1,000.00 | | | |
| :rred Assets: | | | | | |
| Prepaid Insurance | 2,300.00 | 2,000.00 | | | |
| Prepaid Advertising | 3,000.00 | 2,750.00 | | | |
| | $100,000.00 | $98,875.00 | | $100,000.00 | $98,875.00 |

certain changes have occurred in the financial status of John Brown during the month. For example, net worth has increased from $60,000.00 to $64,050.00. There also has been effected a considerable decrease in current liabilities which means a corresponding increase in working capital, which is the excess of the current assets over current liabilities.

Notwithstanding the importance of the conclusions which can be drawn from a study of the comparative balance sheet, it is impossible to explain why the increase in net worth of $4,050.00 occurred. It would be reasonable to assume that it represents net profit for the month of January, but there is no indication that this is the case. It might, for example, represent in part at least, an additional investment on Brown's part. Assuming, however, that it does represent the month's net profit, there is lacking much desirable information relative to the manner in which it was earned. There is no indication of the amount of the operating expenses, and there is no classification of expenses. In brief, one is left entirely uninformed as to the origin of the increase in net worth.

**Nature of Income and Expense.** The impossibility of securing the desired information relative to causes of changes in net worth from the examination of the balance sheet makes it necessary to devise means for recording this information. In other words, it is necessary to give attention to income and expense. It is not sufficient merely to know what the excess of total income over total expense amounts to. This amounts to $4,050.00 in the comparative balance sheet shown in Fig. 19; but it may be asked, what were the sources of income and what was the amount of each? Also, what were the expenses and what was the amount of each? This makes necessary some consideration of the nature of income and expense.

In general, income is that which a business receives from the sale of merchandise or services. This constitutes operating income. Sometimes, however, there are other sources of income which may be listed under the title of nonoperating income. Nonoperating income is that received from investments, from the letting of rooms not needed for the present in the business, and from any other source which is unrelated to the primary operations of a concern. It is evident, therefore, that income must consist of a large number

of small items. For example, in the retail grocery business, sales range from one cent to many dollars. Each such sale represents income. In the case of a firm engaged in the practice of law, fees paid by clients represent income. In the case of a manufacturer of pianos, the sales price of each piano sold is income. In other words, that which a business receives for goods sold, or that which a professional man receives for sales rendered, is income. The student will have no difficulty in calling to mind many illustrations of income received by concerns located in his community.

All such income received does not, however, represent an increase in net worth. Even professional men, such as lawyers, doctors, and accountants must incur expenses. Expenses are paid by business enterprises and professional men in order that they may carry on their work properly. A professional man needs assistants and an office with necessary equipment. The rent paid for the office, the depreciation on the equipment, and the hire of the assistants constitute his expenses. In case of business enterprises, expenses comprise such items as the cost of goods sold, wages, salaries, insurance, taxes, rentals, commissions, advertising, and repairs. Unless such expenses are incurred, business cannot be carried on. It is expected, however, that the total of the expenses will be less than the total of the income. When expenses exceed income, a concern operates at a loss and its net worth is decreased. One of the primary functions of accounting is to help business and professional men to secure accurate information as to the amount of their income and expense, which will enable them to take whatever measures are necessary to remedy unfavorable trends.

**Expense Classification.** Any attempt to classify expenses must be regarded as merely suggestive. Each enterprise must classify its expenses in accordance with their nature and in accordance with the requirements for information. In a broad sense, expenses fall into two fundamental groups, namely: (*a*) operating, (*b*) nonoperating. Ordinarily, the subdivisions of operating expenses are made along lines somewhat as shown in Fig. 20.

**Selling Expenses.** The subclassification of expenses should be carried still further, since detailed information is necessary relative to selling, administrative, financial, and even miscellaneous ex-

1. Operating Expenses
   a) Selling
   b) Administrative
   c) Financial
   d) Miscellaneous

Fig. 20

penses. Therefore the subclassification of selling expenses, as shown in Fig. 21, is suggested:

a) Selling Expenses
   (1) Cost of Goods Sold
   (2) Advertising
   (3) Commissions
   (4) Salaries of Salesmen
   (5) Traveling Expenses
   (6) Freight-out
   (7) Depreciation on Delivery Equipment

Fig. 21

7. *Cost of Goods Sold.* Cost of goods sold is clearly an item of great importance in both merchandising and manufacturing. In case of merchandising, goods are not transformed in character, but they are usually purchased in large quantities and sold in small quantities. It is evident that all goods purchased during a given month or year will not be sold during the same month or year. In other words, there is always an amount held over to be disposed of during the following period. The amount of goods on hand at the end of the accounting period is known as the *closing inventory.* The amount of goods on hand at the beginning of an accounting period is known as the *opening inventory.* In other words, the closing inventory for one period becomes the opening inventory for the following period.

The cost of goods sold for a given accounting period is found by taking into consideration three factors, as shown in Fig. 22.

(*a*) Opening Inventory
(*b*) Purchases during the Period
(*c*) Closing Inventory

Fig. 22

Assuming amounts for each of these items, the cost of goods sold is determined as shown in Fig. 23.

| | |
|---|---|
| *Opening Inventory* | 6,000.00 |
| Add *Purchases* | 18,000.00 |
| | 24,000.00 |
| Less *Closing Inventory* | 8,000.00 |
| *Cost of Goods Sold* | 16,000.00 |

In practice it is necessary to indicate the date of the opening inventory, as well as the date of the closing inventory. Thus, if the date of the opening inventory is April 1, 19—, and the date of the closing inventory is April 30, 19—, the foregoing statement may be revised as shown in Fig. 24.

| | |
|---|---|
| *Inventory April 1, 19—* | 6,000.00 |
| Add *Purchases* | 18,000.00 |
| | 24,000.00 |
| Less *Inventory April 30, 19—* | 8,000.00 |
| *Cost of Goods Sold* | 16,000.00 |

Fig. 24

2. *Advertising.* Advertising is the expense of calling the public's attention to whatever an enterprise has to sell. In some cases advertising is an important item of expense. Sometimes it is nonexistent, as in case of professional men who are not supposed to advertise.

3. *Commissions.* Commissions are paid to salesmen, usually being figured as a per cent on the selling price of the goods sold. This may be an important item of expense where it is customary to give commissions; in some instances, however, it may be a minor item of expense, or it may be even absent from the list of expenses.

4. *Salaries of Salesmen.* This frequently is an item of material importance. The desirability of accurately accounting for such salaries is obvious, since it may at any time be necessary to analyze such expenses and relate them in one way or another to sales.

5. *Traveling Expenses.* In all lines of business, some expenditures on account of traveling expenses are to be expected. In certain lines of business, the item is heavy. For example, a concern which publishes textbooks is likely to require the services of several traveling salesmen. The necessity of accurately accounting for their traveling expenses is evident.

*6. Freight-out.* This is the cost incurred in connection with shipments to customers. When freight-out is paid by the customer, it obviously does not appear in the books of the seller. When it does appear, it is an item of importance and must be accounted for accurately.

*7. Depreciation on Delivery Equipment.* Retail establishments frequently have a large investment in delivery equipment which consists of auto trucks and other types of automobiles. Frequently, the depreciation rate on such equipment is as much as 25 per cent yearly. For analytical purposes, it is necessary that this item of expense be accounted for accurately.

**Administrative Expenses.** Administrative expenses are those incurred primarily in management. In Fig. 25 is shown a tentative classification of administrative expenses.

*a*) Administrative Expenses
- (1) Salaries of Officers
- (2) Office Salaries
- (3) Telephone and Telegraph
- (4) Office Supplies
- (5) Rent
- (6) Heat and Light
- (7) Upkeep

Fig. 25

*1. Salaries of Officers.* Under this heading should be included the salaries of all general officers, such as the president, vice-president, and the secretary-treasurer, as well as others whose duties are primarily administrative. Such salaries should be distinguished easily from salaries paid to men engaged in technical work, such as engineering. The organization chart of a concern should indicate clearly who are the administrative officers, and their salaries should be treated accordingly.

*2. Office Salaries.* This item includes salaries paid to clerical and other help employed in the office. The work of such help should be distinguished easily from the work of those engaged in production and selling.

*3. Telephone and Telegraph.* This item requires little explanation; however, it frequently amounts to a considerable sum and the total

should be subject readily to analysis with a view to avoiding unnecessary expenses of this type.

*4. Office Supplies.* This includes stationery and many miscellaneous items which are essential to the running of an office. There is a tendency to waste office supplies, and it is important that the accounting be done separately and in considerable detail for these items.

*5. Rent.* When the office building is owned by the occupant, there is no rent, but frequently rent is an important item of administrative expense.

*6. Heat and Light.* The nature of this item needs no interpretation; but to achieve economy, care should be taken to keep the cost of heat and light within reasonable limits.

*7. Upkeep.* This includes repairs to office equipment and to the office building, if owned. It covers such items as repairs on calculating machines, typewriters, desks, etc.

**Financial Expenses.** Financial expenses are those incurred in connection with the borrowing of money or obtaining funds in any other way. Interest is likely to be the principal item of financial expense. Discounts on sales are sometimes treated as financial expense. This appears to be the correct procedure when the discount allowed customers is intended primarily to improve the financial standing of the concern. There may be other items falling in this division, but the ones mentioned are most common.

**Miscellaneous Expenses.** Under a suitable classification, most of the operating expenses will fall into one of the groups already mentioned. Sometimes, however, there are extraordinary costs which can be placed only under the heading of *miscellaneous.* Extraordinary losses might be included also, providing they can be regarded as relating to operations. Perhaps the best test of a miscellaneous item of expense is that it is not recurring in nature, but is due to an unusual situation which is not likely to arise again.

**Nonoperating Expense.** A nonoperating expense is one incurred by an enterprise but which is not connected in any way with the primary activity of the enterprise. Thus a man operating a hardware store might decide to sublet some space in his building. This is a nonoperating activity. Expenses incurred in connection there-

with are nonoperating expenses. Income derived therefrom is nonoperating income. It is necessary to distinguish nonoperating income and expense from operating income and expense in order that the net results from operating and nonoperating activities may be accurately determined and explained.

No detailed classification need be attempted for nonoperating expense. It is not likely that any two enterprises would show any uniformity as regards such a classification. In this respect, nonoperating expenses are likely to be peculiar to the operations of the business. Of course, if the nonoperating feature becomes one of great importance, it would be necessary to classify expenses arising in connection therewith in considerable detail.

To illustrate the manner of treating nonoperating expense, assume that a concern purchases a tract of land which it holds for future development. Many of the expenditures made in connection therewith should be added to the cost of the land, but some of these expenditures should be regarded as current expense and, of course, would be nonoperating in character. These nonoperating expenses would become operating expenses whenever the land might be used in connection with the operations of the concern. Nonoperating expenses should not be confused with miscellaneous operating expenses. The latter are in some way related to operations, whereas nonoperating expenses are in no way related to the primary undertaking of the concern.

**Revenue Classification.** Revenues taken together comprise the income of an enterprise. These revenues should be more than sufficient to offset the expenses classified and explained in preceding pages. As a rule, there is one primary source of revenue, namely, sales of merchandise, or of services, or both. A few illustrations will indicate the nature of revenue or income. A railroad receives revenue from its freight service and from its passenger service. A drug store receives revenue from the sale of drugs, drinks, and toilet articles. A bus line secures revenue from the transportation of passengers. A commercial airline secures revenue from the transportation of passengers and mail.

The total revenue received is called frequently *gross income.* Obviously, such gross income does not represent the amount of in-

crease in the net worth. From this must be deducted all expenses of carrying on business. When from gross income are deducted all operating expenses, the result is either *net profit* or *net loss*. If a business is prosperous, this income should exceed operating expenses and there should be as a result a *net operating profit*.

Just as there may be nonoperating expenses, so there may also be nonoperating revenue or income. Just as nonoperating expenses should be accounted for separately, so nonoperating revenue or income should be accounted for separately. Before the final effect of all transactions upon net worth can be determined, the operating net profit must be adjusted for the amount of the net profit of a nonoperating character. This results in a final figure called *net profit* or *net income*.

Since the sources of operating and of nonoperating income are usually few in number, a classification thereof need not be shown in as great detail as is the case with operating and nonoperating expense; however, for illustrative purposes, brief classifications of operating income and nonoperating income are shown in Figs. 26 and 27, respectively. These are illustrative of sales made by a department store.

1. Operating Income
   *a*) Sales of Merchandise
      (1) Men's Clothing
      (2) Women's Clothing
      (3) Groceries
      (4) Hardware, etc.
   *b*) Sales of Services
      (1) Tailoring
      (2) Sewing Lessons, etc.

Fig. 26

2. Nonoperating Income
   *a*) Interest
   *b*) Dividends
   *c*) Rental of Space not needed in business, etc.

Fig. 27

**Comments on Income Items.** It is unnecessary to present an itemized discussion of the various sources of operating and nonoperating income. Sales of merchandise obviously will be sub-

divided into few or many groups, according to the size and character of the enterprise. Those listed in Fig. 26 are intended to be merely suggestive. Instead of four groups of sales, there might be twenty. The subdivision of sales into such groups as men's clothing, women's clothing, etc., is intended to make possible the analysis of income and expense on a departmental basis. It is obvious, of course, that where sales are thus subdivided there should be a corresponding subdivision of expense, otherwise the information needed to locate unprofitable lines will not be forthcoming.

Likewise, the mention of tailoring and sewing lessons under Sales of Services is merely suggestive. A department store might not sell any services, on the other hand it might sell a half-dozen services for which it would be desirable to account for separately in order to determine which are profitable and which are unprofitable. As regards nonoperating income, the classification shown in Fig. 27 is again only suggestive. If a concern has investments in bonds and stocks, it will derive an income therefrom in the form of interest and dividends. If it has floor space which it does not need in its own business, it will derive a rental from the subletting of such space. It is possible that there may be other sources of nonoperating income than those indicated in Fig. 27. As a rule, each source of nonoperating income should be accounted for separately, in order that the manager may at any time be able to judge whether or not changes in policy regarding investments and the subletting of floor space may be desirable.

**How Profit and Loss Data Are Secured.** In actual business, the income and expense data, which have been discussed previously, must be secured from accurately kept records. The principles underlying these records and the forms of these records, as well as the manner in which they are to be kept, are explained in this text. At this point, it is necessary that the student understand that balance sheets and profit and loss statements cannot be prepared except when the necessary information is forthcoming. This information sometimes is found only in the form of memoranda, but where the records are kept properly the information is secured through standardized accounting procedures. These procedures should be the subject of careful study. They will be outlined and

explained in succeeding chapters. The illustrations of profit and loss statements which follow are based on assumed amounts, but in practice the amounts shown in both balance sheet and profit and loss statement are not assumed, being based on actual records of all financial transactions which concern a given enterprise.

**Profit and Loss Statements.** In view of the explanations given previously, the profit and loss statement shown in Fig. 28 should be understood readily. It is the statement of a sole proprietor, T. A. Sullivan, for the month ended January 31, 19—. Note that from sales is deducted cost of goods sold to arrive at gross profit. From gross profit, operating expenses are deducted under three heads, namely, selling, administrative, and financial. The final result is the net profit for the month, an increase in Sullivan's net worth.

In Fig. 29 is shown the statement of profit and loss of Lawson

**T. A. Sullivan**

PROFIT AND LOSS STATEMENT

**Month Ended January 31, 19--**

| | | | |
|---|---|---|---|
| *Sales* | | | 100,000.00 |
| Less *Cost of Goods Sold:* | | | |
| *Inventory January 1, 19--* | | 60,000.00 | |
| *Purchases* | | 90,000.00 | |
| | | 150,000.00 | |
| *Inventory January 31, 19--* | | 68,000.00 | 82,000.00 |
| *Gross Profit* | | | 18,000.00 |
| Less *Operating Expenses:* | | | |
| *Selling:* | | | |
| *Traveling Expenses* | 2,150.00 | | |
| *Advertising* | 150.00 | | |
| *Salaries of Salesmen* | 4,428.00 | | |
| | | 6,728.00 | |
| *Administrative:* | | | |
| *Salaries* | 6,450.00 | | |
| *Telephone and Telegraph* | 125.00 | | |
| *Office Supplies* | 98.00 | | |
| *Heat and Light* | 76.00 | | |
| | | 6,749.00 | |
| *Financial:* | | | |
| *Interest* | | 12.00 | |
| *Total Operating Expense* | | | 13,489.00 |
| *Net Profit* | | | 4,511.00 |

Fig. 28

and Cook, a partnership. In this case, the accounting period is one year, the closing date being December 31, 19—. Note that in general the construction of the statement is similar to that of T. A. Sullivan; however, interest is not listed as a financial item, and after expenses of operation are deducted, net operating profit of

**Lawson and Cook**

PROFIT AND LOSS STATEMENT

**Year Ended December 31, 19—**

| | | | |
|---|---|---|---|
| *Net Sales* | | | 310,000.00 |
| Less *Cost of Goods Sold:* | | | |
| *Inventory, December 31, 19—* | | 40,000.00 | |
| *Purchases* | | 200,000.00 | |
| | | 240,000.00 | |
| *Deduct Inventory, December 31, 19—* | | 42,000.00 | |
| *Cost of Goods Sold* | | | 198,000.00 |
| *Gross Profit* | | | 112,000.00 |
| *Deduct Expenses of Operation:* | | | |
| *Selling:* | | | |
| *Salaries* | 30,000.00 | | |
| *Traveling Expenses* | 15,000.00 | | |
| *Advertising* | 5,040.00 | | |
| | | 50,040.00 | |
| *Administrative:* | | | |
| *Salaries* | 40,000.00 | | |
| *Rent* | 7,000.00 | | |
| *Office Supplies* | 3,000.00 | | |
| | | 50,000.00 | |
| *Total Operating Expense* | | | 100,040.00 |
| *Net Operating Profit* | | | 11,960.00 |
| Add *Nonoperating Income:* | | | |
| *Interest* | 310.00 | | |
| *Discount on Purchases* | 400.00 | | |
| | | 710.00 | |
| Deduct *Nonoperating Expense:* | | | |
| *Interest* | 170.00 | | |
| *Discount on Sales* | 500.00 | | |
| | | 670.00 | 40.00 |
| *Net Profit* | | | 12,000.00 |
| *Distribution of Profit:* | | | |
| *Lawson (60 per cent)* | | | 7,200.00 |
| *Cook (40 per cent)* | | | 4,800.00 |
| | | | 12,000.00 |

Fig. 29

$11,960.00 is shown. This is adjusted for nonoperating income and expense, resulting in a final net profit of $12,000.00. The manner in which this is distributed is shown underneath the statement.

In Fig. 30 is shown the statement of profit and loss for The Lawson-Cook Company, a corporation. This is the same statement as shown in Fig. 29, except that it has been changed to represent the statement of profit and loss for a corporation. Note that the final net profit is indicated as being carried to surplus.

**The Lawson-Cook Company**

PROFIT AND LOSS STATEMENT

**Year Ended December 31, 19—**

| | | | |
|---|---|---|---|
| *Net Sales* | | | 310,000.00 |
| Less *Cost of Goods Sold:* | | | |
| *Inventory, December 31, 19—* | | 40,000.00 | |
| *Purchases* | | 200,000.00 | |
| | | 240,000.00 | |
| *Deduct Inventory, December 31, 19—* | | 42,000.00 | |
| *Cost of Goods Sold* | | | 198,000.00 |
| *Gross Profit* | | | 112,000.00 |
| *Deduct Expenses of Operation:* | | | |
| *Selling:* | | | |
| *Salaries* | 30,000.00 | | |
| *Traveling Expenses* | 15,000.00 | | |
| *Advertising* | 5,040.00 | | |
| | | 50,040.00 | |
| *Administrative:* | | | |
| *Salaries* | 40,000.00 | | |
| *Rent* | 7,000.00 | | |
| *Office Supplies* | 3,000.00 | | |
| | | 50,000.00 | |
| *Total Operating Expense* | | | 100,040.00 |
| *Net Operating Profit* | | | 11,960.00 |
| Add *Nonoperating Income* | | | |
| *Interest* | 310.00 | | |
| *Discount on Purchases* | 400.00 | | |
| | | 710.00 | |
| Deduct *Nonoperating Expense* | | | |
| *Interest* | 170.00 | | |
| *Discount on Sales* | 500.00 | | |
| | | 670.00 | 40.00 |
| *Net Profit Carried to Surplus* | | | 12,000.00 |

Fig. 30

# *Chapter* 4

# DEBIT AND CREDIT EXPLAINED

**Résumé.** In preceding chapters attention has been directed to the uses of accounting and to the important financial statements, namely, the balance sheet and the statement of profit and loss. In the illustrations of these statements assumed amounts were used. In practice, however, the amounts shown in a balance sheet and a profit and loss statement cannot be assumed, but must be derived from carefully kept records.

**Analysis of Business Transactions.** The transactions which occur daily in business are of an almost infinite variety. Most of them represent such routine occurrences as sales, purchases, and the paying of expenses. Sometimes, however, transactions of extraordinary character occur. Sometimes, it is necessary to make adjustments on account of discrepancies and mistakes. All of these transactions have their influence upon the financial status of an enterprise. Anything connected therewith cannot be overlooked. Everything must be recorded, summarized, and interpreted.

Several illustrations of transactions may at this point be considered from the point of view of analysis. By analysis is meant the interpretation of the meaning of a transaction.

*1. Investment in Business.* Suppose that Arthur Smith desires to enter the retail hardware business and that he has $10,000.00 in cash to invest. Obviously, the investment of $10,000.00 in cash is in itself a transaction. As long as Smith keeps the $10,000.00 in his personal bank account, it represents a part of his personal estate, but the moment he draws a check for $10,000.00 and deposits this check in another account entitled Arthur Smith, Retail Hardware, the $10,000.00 becomes an asset of the business and the business in which it is invested may be said to owe Smith $10,000.00. In other words the $10,000.00 invested in the hardware business represents an entity distinct from Smith's personal estate.

It may be well to emphasize the fundamental importance of distinguishing between one's strictly personal estate and one's business. This is important not only from the point of view of being able to tell what one has invested in business, but also from the point of view of relationships with outsiders and with the state. One cannot report properly for his income tax unless he makes this distinction. Then, too, there are other matters, such as reports to associations and possibly to the government, which make it necessary to draw a line between one's business and one's other interests.

Returning to the illustration in which Smith invests $10,000.00 in business, it may be asked what is the real nature of this transaction and is there any particular analysis to be made thereof? Since Smith's business is to be regarded as a separate entity and records thereof are kept separate from the records which Smith keeps for his personal estate, it is evident that the transactions may be viewed from the point of view of (*a*) Arthur Smith, Retail Hardware, and (*b*) Arthur Smith as an individual.

At once it will be observed that Arthur Smith, Retail Hardware, and Arthur Smith, individual, have entered into a relationship with each other. Arthur Smith, individual, has advanced $10,000.00 to Arthur Smith, Retail Hardware. Clearly, Arthur Smith, individual, has not given the money away. He has $10,000.00 less cash but in place thereof he has an investment in a business of Arthur Smith, Retail Hardware. In other words, he has surrendered one asset for another one which he has received.

Now, viewing the transaction from the point of view of Arthur Smith, Retail Hardware, it is evident that Arthur Smith, Retail Hardware, now has $10,000.00 in cash for which amount he is under obligation to Arthur Smith, individual. In other words, for the receipt of $10,000.00 in cash, Arthur Smith, Retail Hardware, acknowledges a kind of indebtedness for that amount to Arthur Smith, individual.

Assuming that records are to be kept by Arthur Smith, individual, and also by Arthur Smith, Retail Hardware, there are various ways in which entry might be made on both records for this transaction. For example, if records are merely in the form of memoranda, Arthur Smith might make the following entry:

On records of Arthur Smith, individual:

This day draws check for $10,000.00, in favor of Arthur Smith, Retail Hardware. Intention is to engage in the retail hardware business beginning this date, January 1, 19—.

On the records of Arthur Smith, Retail Hardware:

This day receives check for $10,000.00 from Arthur Smith. This amount is to be deposited in the bank account of Arthur Smith, Retail Hardware, and to be used to carry on a retail hardware business beginning today, January 1, 19—.

If, however, the entry on both records is to be made in the form which accountants regard as correct, it will follow the technical arrangement shown in Figs. 31 and 32.

On records of Arthur Smith, individual:

| | | |
|---|---|---|
| *January 1, 19—* | | |
| *Arthur Smith, Retail Hardware* | *10,000 00* | |
| *Cash* | | *10,000 00* |
| *For investment in retail hardware business, to be opened this day at 220 North Street.* | | |

Fig. 31

On records of Arthur Smith, Retail Hardware, the entry is as shown in Fig. 32.

| | | |
|---|---|---|
| *January 1, 19—* | | |
| *Cash* | *10,000 00* | |
| *Arthur Smith, Capital* | | *10,000.00* |
| *For investment by Arthur Smith in retail hardware business, opened this day at 220 North Street.* | | |

Fig. 32

These entries, which may be said to be in technical form, follow an arrangement which has been sanctioned by many years of experience on the part of bookkeepers and accountants. It cannot be said that no other arrangement would serve the purpose; however, this arrangement appears to fulfill all requirements as regards analysis of the individual transaction and also as regards the showing of all necessary information. Referring to Fig. 31, and using accounting terminology, it is said that Arthur Smith, Retail Hardware, is debited $10,000.00, and that Cash is credited $10,000.00. Here the words *debit* and *credit* are used in a technical sense which will be explained further. Referring to Fig. 32, it is said that on the

records of Arthur Smith, Retail Hardware, cash is *debited* $10,000.00 and Arthur Smith, Capital is *credited* $10,000.00. Here again the *debit* and *credit* are used in a technical accounting sense which will be explained further.

2. *Purchase of Merchandise.* Assume that on January 1, 19—, Arthur Smith, Retail Hardware, purchases $1,000.00 worth of merchandise for cash and $500.00 worth of merchandise on account from Olson Wholesale Hardware Company. From this point on, the entries shown will be those for Arthur Smith, Retail Hardware, only. Of course, entries will be made on the records of those with whom Arthur Smith, Retail Hardware, carries on transactions; but in order to simplify the study of principles, attention will be limited to the records of Arthur Smith, Retail Hardware. In this instance, the transaction might be written out in memorandum form, but this is unnecessary, since correct accounting procedure is to be studied. The entry for the purchase of the merchandise for cash is shown in Fig. 33. The entry for the purchase of merchandise on account is shown in Fig. 34.

| | | |
|---|---|---|
| *January 1, 19—* | | |
| *Purchases* | *1,000.00* | |
| *Cash* | | *1,000.00* |
| *For purchase of merchandise for cash.* | | |

Fig. 33

| | | |
|---|---|---|
| *January 1, 19—* | | |
| *Purchases* | *500.00* | |
| *Olson Wholesale Hardware Company* | | *500.00* |
| *For purchase of merchandise on account, terms 2 per cent 10 days, net 30 days.* | | |

Fig. 34

3. *Pays for Advertising.* Assume next that Arthur Smith, Retail Hardware, pays $10.00 for advertising in a local newspaper. This expense is incurred in order to call the public's attention to the fact that the new hardware store is open. The entry in technical accounting form for this transaction is shown in Fig. 35.

| | | |
|---|---|---|
| *January 1, 19—* | | |
| *Advertising Expense* | *10.00* | |
| *Cash* | | *10.00* |
| *For advertising in News-Bee.* | | |

Fig. 35

The student will note that in this case cash is paid out, but no asset or property is received in return. This is an example of the negative factors mentioned previously. Smith is willing to incur this reduction in his net worth or capital because he believes that it will be more than outweighed by the benefits derived from sales of hardware. There are many kinds of expense which in themselves appear to be unfavorable because they directly reduce the proprietor's capital or net worth. They are justified, however, because of the advantages which ultimately result. Therefore expenses, although negative in their direct effect, are beneficial in their indirect effect because business cannot be carried on unless necessary expenses are incurred.

*4. Pays Rent.* Arthur Smith, Retail Hardware, pays rent for the month of January, $90.00. This expenditure, like that for advertising, is in itself unfavorable, but it is a necessary expense, and together with all other necessary expenses should be more than offset by the profits made on the sale of merchandise. Of course, this may not be true for the first month or even for several months, since it takes time to get a business on a going concern basis by attracting purchasers. Nevertheless, the payment of rent, when made monthly, is obviously a monthly expense and, as will be explained later, must be listed with all other expenses applicable to the month of January so that the total expenses can be compared with the positive or favorable results secured from sales of merchandise. The entry in the technical accounting form for the payment of the rent is shown in Fig. 36.

| | | |
|---|---|---|
| | *January 1, 19—* | |
| *Rent Expense* | *90.00* | |
| *Cash* | | *90.00* |
| *For payment of rent for January.* | | |

Fig. 36

*5. Sells Merchandise.* Suppose that Arthur Smith, Retail Hardware, sells merchandise as follows:

| | |
|---|---|
| *1. Cash* | *107.30* |
| *2. J. B. Lister* | *30.00* |
| *3. Johnson Company* | *27.40* |

The sales to J. B. Lister and to Johnson Company are on account. Although this merchandise is sold at a price considerably

above its cost, there is no indication of this fact in the foregoing list of sales. However, the student should keep this in mind, for later on it will be necessary to determine what the excess of the selling price is over the cost of the goods sold. The technical accounting entries for these sales are shown in Figs. 37, 38, and 39.

| | | |
|---|---|---|
| *Cash* | *107.30* | |
| *Sales* | | *107.30* |
| *Cash sales for January 2.* | | |

Fig. 37

| | | |
|---|---|---|
| *J. B. Lister* | *30.00* | |
| *Sales* | | *30.00* |
| *For sale on account.* | | |

| | | |
|---|---|---|
| *Johnson Company* | *27.40* | |
| *Sales* | | *27.40* |
| *For sale on account.* | | |

Fig. 39

These entries record revenue. This revenue, however, does not represent in its entirety an increase in net worth. The total sales for the day amount to $164.70. If it be assumed that the cost of the goods sold is $110.00 and that all expenses applicable to the day's business amount to $20.00, then the total cost of the day's business is $110.00, plus $20.00, or $130.00, which subtracted from $164.70 leaves $34.70 as the net increase in capital or net worth. The student must understand that these costs and expenses are merely assumed at this point. He will learn later how, at the end of the accounting period, the results for the month are actually summarized and the net profit for the month secured.

**Comments on Preceding Transactions.** The preceding illustrations are typical of those which occur in business. It is evident that each transaction has a twofold meaning, or, in other words, that when analyzed each transaction indicates two effects. For example, in case of the second transaction, a purchase of merchandise involves the payment of cash as well as the receipt of the goods, and in the third transaction, the paying for advertising involves the reduction of net worth and the payment of cash. In order to secure a better understanding of this matter of analysis of transactions, it will be necessary, next, to explain the form and use of the *account*.

**The Account.** An *account* is a form particularly adapted for the recording of financial facts relating to a given item of income, expense, asset, liability, or net worth. A form of the account is shown in Fig. 40.

TITLE OF ACCOUNT

| Date | Explanation | Fol. | Amount | Date | Explanation | Fol. | Amount |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |

Fig. 40

The account form is made to vary considerably to meet different requirements. The one shown in Fig. 40 may be regarded as standard. It may be desirable, for purposes of illustration, to simplify it somewhat although in practice it is customary to use a form drawn up in full detail.

The student will note that the two sides of the account are identical. First, there is a column for the date, then explanation, next folio, and finally the amount. As explained later in this chapter, the purpose of the folio column is to indicate the journal page from which the amount entered in the account is carried, or posted. The two sides of the account are necessary, because increases and decreases applicable to a particular item must be recorded. Increases are shown on one side of the account and de-

creases are shown on the other side. It is in this connection that it is necessary to develop what is known as the rules of debit and credit. A *debit* is always entered on the left-hand side of the account and a *credit* is always entered on the right-hand side of the account. However, the meaning of debit and credit differs for different accounts; thus if an account is opened entitled Cash, increases in cash are expressed as debits and decreases of cash are shown as credits. If however, an account is opened with John Jones, Net Worth, it cannot be said that this account is debited for receipts of net worth and credited for payments of net worth. It is correct, however, to say that this account is credited for increases in net worth and debited for decreases in net worth. Taking the transaction shown in Fig. 32, and opening skeleton, or outline, accounts for Cash and for Arthur Smith, Capital, the information may be shown as expressed in Fig. 41.

**Cash**

| | |
|---|---|
| 10,000.00 | |

**Arthur Smith, Capital**

| | |
|---|---|
| | 10,000.00 |

Fig. 41

The purpose in giving the illustrations shown in Figs. 40 and 41 is to enable the student to understand that the analyses of transactions must be made to correspond with accounts. There may be as many accounts as conditions require. Thus there should be accounts kept for all current assets, fixed assets, investments, and intangible assets. There must also be accounts for all liabilities, both current and fixed, and there must be one or more accounts for net worth. In addition, there must be accounts for all classes of revenue and expense.

In other words, every enterprise must have an *account classification* adapted to its own requirements. Such an account classification will be somewhat like the classification of assets, liabilities, expenses, and revenues discussed in Chapters 2 and 3. There are naturally variations as to individual accounts in different enterprises. In Fig. 42 is shown a classification of accounts based on the classifications given in Chapters 2 and 3.

## CLASSIFICATION OF ACCOUNTS

A. Asset Accounts
  1. Current Asset Accounts
    *a*) Cash
      (1) In Bank
      (2) On Hand
    *b*) Merchandise
    *c*) Accounts Receivable
    *d*) Notes Receivable
    *e*) Acceptances Receivable
    *f*) Temporary Investments
  2. Fixed Asset Accounts
    *a*) Land
    *b*) Buildings
    *c*) Machinery
    *d*) Furniture and Fixtures
    *e*) Delivery Equipment
  3. Investment Account
  4. Intangible Asset Accounts
    *a*) Goodwill
    *b*) Patents
    *c*) Trademarks
    *d*) Franchises

B. Liability Accounts
  1. Current Liability Accounts
    *a*) Accounts Payable
    *b*) Notes Payable
    *c*) Dividends Payable
    *d*) Accrued Taxes
  2. Fixed Liability Accounts
    *a*) Mortgage Payable
    *b*) Bonds Payable

C. Net Worth Accounts
  1. Sole Proprietorship
    *a*) Capital Account
  2. Partnership
    *a*) Capital Accounts
    *b*) Drawings Accounts
  3. Corporations
    *a*) Capital Stock Accounts
      (1) Common
      (2) Preferred
    *b*) Surplus Accounts
      (1) Earned
      (2) Capital

D. Expense Accounts
  1. Operating Expense Accounts

Fig. 42—*Continued on following page.*

- *a*) Selling Expense Accounts
  - (1) Cost of Goods Sold
  - (2) Advertising
  - (3) Commissions
  - (4) Salaries of Salesmen
  - (5) Traveling Expenses
  - (6) Freight-out
  - (7) Depreciation, Delivery Equipment
- *b*) Administrative Expense Accounts
  - (1) Salaries of Officers
  - (2) Office Salaries
  - (3) Telephone and Telegraph
  - (4) Office Supplies
  - (5) Rent
  - (6) Heat and Light
  - (7) Upkeep

E. Revenue Accounts
- 1. Operating Revenue Accounts
  - *a*) Sales of Merchandise Accounts
    - (1) Men's Clothing
    - (2) Women's Clothing
    - (3) Groceries
    - (4) Hardware
  - *b*) Sales of Services Accounts
    - (1) Tailoring
    - (2) Sewing Lessons
- 2. Nonoperating Revenue Accounts
  - *a*) Interest
  - *b*) Dividends
  - *c*) Rental of Space not needed in business

Fig. 42

**Rules for Debit and Credit.** Essentially all accounts group themselves under the general outline shown in Fig. 43.

Assets
Liabilities
Net Worth

Fig. 43

These three subdivisions of accounts arrange themselves as opposites as shown in Fig. 44.

| (*Debit Side*) | (*Credit Side*) |
|---|---|
| *Assets* | *Liabilities*<br>*Net Worth* |

Fig. 44

It is the universal practice to show the amount of assets on the left or debit side of the asset accounts, as well as to show additions thereto on the left, or debit, side of the asset accounts and to show deductions therefrom on the right or credit side of the asset accounts.

It is the universal practice to show liabilities and net worth on the right, or credit side, of the liability accounts and the net worth accounts, to show *increases* in liabilities and net worth on the *right, or credit, side* of the liability accounts and the net worth accounts, and to show *decreases* in liabilities and in net worth *on the left, or debit, side* of the liability accounts and the net worth accounts.

These principles may be stated in the form of rules, as follows:

*Assets:*

Show increases on left-hand side of the account. This is termed *debiting* the account.

Show decreases on right-hand side of the account. This is termed *crediting* the account.

*Liabilities:*

Show increases on the right-hand side of the account. This is termed *crediting* the account.

Show decreases on left-hand side of the account. This is termed *debiting* the account.

*Net Worth:*

Show increases on right-hand side of the account. This is termed *crediting* the account.

Show decreases on left-hand side of the account. This is termed *debiting* the account.

These rules may be restated as follows:

Debit:

1. Increases in assets
2. Decreases in liabilities
3. Decreases in net worth

Credit:

1. Decreases in assets
2. Increases in liabilities
3. Increases in net worth

Debits and credits invariably occur in pairs. It is impossible to have a debit without a corresponding credit or credits of equal amount; or, to reverse the statement, it is impossible to have a credit without having a corresponding debit or debits of equal

amount. This is known as the *principle of double entry* and may be restated in detail, as follows, to cover most of the transactions that occur in practice:

1. When an asset is debited, an equal credit occurs to one or more of the following accounts:
   *a*) Another asset account
   *b*) A liability account
   *c*) A net worth account
2. When an asset is credited, an equal debit occurs to one or more of the following accounts:
   *a*) Another asset account
   *b*) A liability account
   *c*) A net worth account
3. When a liability is credited, an equal debit occurs to one or more of the following accounts:
   *a*) Another liability account
   *b*) An asset account
   *c*) A net worth account
4. When a liability is debited, an equal credit occurs to one or more of the following accounts:
   *a*) Another liability account
   *b*) An asset account
   *c*) A net worth account
5. When net worth is credited, an equal debit occurs to one or more of the following accounts:
   *a*) Another net worth account
   *b*) An asset account
   *c*) A liability account
6. When net worth is debited, there occurs an equal credit to one or more of the following accounts:
   *a*) Another net worth account
   *b*) An asset account
   *c*) A liability account

**Temporary Net Worth Accounts.** All revenue accounts and all expense accounts are simply temporary net worth accounts and, as will be explained later, the amounts which accumulate in these temporary net worth accounts are transferred to the permanent net worth accounts. The final result is the same as if all items of income and all items of expense were entered in the first place in the net worth account or accounts. The reason that this is not done is because detailed information is needed relative to the various kinds of revenue and expense. In view of this fact, the explanation of the rules of debit and credit may be continued as follows:

7. When an expense account is debited, there occurs an equal credit to one or more of the following accounts:
   *a*) Another expense account
   *b*) An asset account
   *c*) A liability account
8. When an expense account is credited, there occurs an equal debit to one or more of the following accounts:
   *a*) An asset account
   *b*) A liability account
   *c*) A net worth account
9. When a revenue account is debited, there occurs an equal credit to one or more of the following accounts:
   *a*) An asset account
   *b*) A liability account
   *c*) A net worth account
10. When a revenue account is credited, there occurs an equal debit to one or more of the following accounts:
   *a*) An asset account
   *b*) Another revenue account
   *c*) A net worth account

The foregoing restatement in detail, in items 1 to 10, of the principle of double entry covers most of the cases which arise in practice. All cases are covered by the rules for debit and credit stated on page 61.

**Rules for Debit and Credit Illustrated.** Below are given a series of transactions for the business of James Morton, Retail Grocer, for the week ending January 7, 19—. The purpose of these transactions is to illustrate the application of the rules for debit and credit, and also to show how accounts may be set up for all of the various assets, liabilities, net worth, income and expense.

January 2. James Morton engages in the retail grocery business, investing cash to the amount of $9,000.00.

This transaction results in an increase in assets and an equal increase in net worth for the business of James Mortoh, Retail Grocer. The entry on Morton's books is as follows:

| | | |
|---|---|---|
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *9,000.00* | |
| *James Morton, Net Worth* . . . . . . . . . . | | *9,000.00* |
| *For investment in the retail grocery business.* | | |

In the foregoing entry, Cash is debited because it represents an increase in assets. James Morton, Net Worth, is credited because it represents an increase in net worth.

January 2. Pays rent for a month, $60.00.

This is a double entry in which a temporary Net Worth account, that is, an Expense account, is debited and Cash account is credited. The entry is as follows:

| | | |
|---|---|---|
| *Rent Expense*.................................... | *60.00* | |
| *Cash*.................................... | | *60.00* |
| *For rent for January.* | | |

In this entry, Rent Expense is debited because it represents a decrease in net worth, and Cash is credited because it represents a decrease in assets.

January 2. Purchases merchandise for cash $500.00.

This is a transaction in which one asset, Merchandise, is increased and another asset, Cash, is decreased. The entry is as follows:

| | | |
|---|---|---|
| *Purchases*.................................... | *500.00* | |
| *Cash*.................................... | | *500.00* |
| *For purchase of merchandise.* | | |

In the foregoing entry, Purchases account is debited because this represents an increase in assets; Cash account is credited because this represents a decrease in assets.

January 2. Purchases merchandise on account from Globe Wholesale Company, $1,500.00, terms 2 per cent 10 days, net 30 days.

For this transaction, Purchases account is debited and Globe Wholesale Company is credited in the following entry.

| | | |
|---|---|---|
| *Purchases*.................................... | *1,500.00* | |
| *Globe Wholesale Company*.......................... | | *1,500.00* |
| *For purchase of merchandise on account.* | | |

In the foregoing entry, Purchases account is debited because it represents an increase in assets, and Globe Wholesale Company account is credited because it represents an increase in liabilities.

January 2. Pays for advertising in local newspaper, $15.00.

The entry for this transaction is as follows:

| | | |
|---|---|---|
| *Advertising Expense*.................................. | *15.00* | |
| *Cash*.................................... | | *15.00* |
| *For advertisement in Morning Times.* | | |

In the foregoing entry, Advertising Expense account is debited

because it represents a decrease in net worth. Cash account is credited because it represents a decrease in an asset.

January 2. Sells merchandise for cash $93.20.

The entry is as follows:

| | | |
|---|---|---|
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *93.20* | |
| *Sales*. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *93.20* |
| *Cash sales for the day.* | | |

In the foregoing entry, Cash account is debited because an asset is increased. Sales account is credited because it represents both a decrease in an asset and presumably an increase in net worth. In practice it is impossible to separate the amount of profit on a sale from the cost of the goods sold. Assuming, however, that in the foregoing transaction the goods sold for $93.20 and cost $60.00, the entry could be made as follows:

| | | |
|---|---|---|
| *Cash*. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *93.20* | |
| *Purchases*. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *60.00* |
| *Profit on Sale*. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *33.20* |

The student must note that in practice the subdivision of sales into cost and profit cannot be made directly for each sale. The foregoing entry is made merely to indicate the true nature of a sale. In practice the determination of profit must be delayed until the end of the accounting period.

Applying the rules of debit and credit to the foregoing entry, it may be said that Cash is debited because an asset is increased and that Purchases is credited $60.00 because an asset is decreased; also that Profit on Sales is credited $33.20 because net worth is increased that amount.

January 2. Sells on account to Arthur Best, merchandise $12.20. The entry for this transaction is as follows:

| | | |
|---|---|---|
| *Arthur Best*. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *12.20* | |
| *Sales*. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *12.20* |
| *For sale on account.* | | |

In the foregoing entry, Arthur Best is debited because his account represents an increase in assets. Sales is credited because it represents presumably a decrease in assets and an increase in net worth. As explained above, it is not practicable to analyze sales into cost of goods sold and profit for each sales transaction.

January 2. Purchases chairs, counters, and show cases for store from Mentor Wholesale Company, $450.00 on account, terms 2 per cent 10 days, net 60 days. The entry for this transaction is as follows:

| | | |
|---|---|---|
| *Furniture and Fixtures* | *450.00* | |
| *Mentor Wholesale Company* | | *450.00* |
| *For purchase of furniture for store.* | | |

In the foregoing entry, Furniture and Fixtures account is debited because it represents an increase in assets. Mentor Wholesale Company is credited because it represents an increase in liabilities.

January 3. Purchases supplies sufficient for one month for cash $15.00. The entry is as follows:

| | | |
|---|---|---|
| *Supplies* | *15.00* | |
| *Cash* | | *15.00* |
| *For purchase of supplies for January.* | | |

In the foregoing entry, Supplies account is debited because an asset is increased and Cash account is credited because an asset is decreased.

The following transactions complete the business for the week. The student should have no difficulty in explaining the entry given after each transaction. He should determine which debit rule and which credit rule applies in each case.

January 4. Cash sales for day, $102.20. Sale on account to James Moran, $18.42. The entries are:

| | | |
|---|---|---|
| *Cash* | *102.20* | |
| *Sales* | | *102.20* |
| *For cash sales for day.* | | |
| *James Moran* | *18.42* | |
| *Sales* | | *18.42* |
| *Sale on account.* | | |

January 5. Purchases merchandise for cash $200.00. Sells on account to S. A. Atkins merchandise amounting to $12.00, terms 2 per cent 10 days, net 30 days. Cash sales for day, $85.00. The entries are:

| | | |
|---|---|---|
| *Purchases* | *200.00* | |
| *Cash* | | *200.00* |
| *For purchases of cash.* | | |

| | | |
|---|---|---|
| *S. A. Atkins* | *12.00* | |
| *Sales* | | *12.00* |
| *For sale on account, terms 2 per cent 10 days, net 30 days.* | | |
| *Cash* | *85.00* | |
| *Sales* | | *85.00* |
| *For cash sales for day.* | | |

January 6. Cash sales for day, \$120.10.

| | | |
|---|---|---|
| *Cash* | *120.10* | |
| *Sales* | | *120.10* |
| *For cash sales for day.* | | |

January 7. Cash sales for day, \$110.00.

| | | |
|---|---|---|
| *Cash* | *110.00* | |
| *Sales* | | *110.00* |
| *For cash sales for day.* | | |

The entries for the transactions shown above are called *journal entries* by accountants. They are made in a book called the *journal*, which will be explained fully in the following chapter. When the items shown in these journal entries are rearranged in accordance with the accounts affected, the result is as shown in the following list of accounts. Transferring this information from the journal entries to the accounts is known technically as *posting*. This will be fully explained later. The accounts are kept in a book known as the *ledger;* therefore, the following accounts may be regarded as the ledger of James Morton.

**Cash**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 2 | *J. Morton, Net Worth* | *J1* | *9,000* | *00* | *Jan.* | 2 | *Rent Expense* | *J1* | *60* | *00* |
| | | | | | | | 2 | *Purchases* | *J1* | *500* | *00* |
| | 2 | *Sales* | *J1* | *93* | *20* | | 2 | *Advertising Expense* | *J1* | *15* | *00* |
| | 4 | *Sales* | *J1* | *102* | *20* | | 3 | *Supplies* | *J1* | *15* | *00* |
| | 5 | *Sales* | *J1* | *85* | *00* | | 5 | *Purchases* | *J1* | *200* | *00* |
| | 6 | *Sales* | *J1* | *120* | *10* | | | | | | |
| | 7 | *Sales* | *J1* | *110* | *00* | | | | | | |

**James Morton, Net Worth**

| | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | *Jan.* | 2 | *Cash* | *J1* | *9,000* | *00* |

### Rent Expense

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | | | |
| *Jan.* | 2 | *Cash* | *J1* | 60 | 00 | | | | | | |

### Purchases

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | | | |
| *Jan.* | 2 | *Cash* | *J1* | 500 | 00 | | | | | | |
| | 2 | *Globe Mfg. Co.* | *J1* | 1,500 | 00 | | | | | | |
| | 5 | *Cash* | *J1* | 200 | 00 | | | | | | |

### Globe Wholesale Company

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 19— | | | | | |
| | | | | | | *Jan.* | 2 | *Purchases* | *J1* | 1,500 | 00 |

### Advertising Expense

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | | | |
| *Jan.* | 2 | *Cash* | *J1* | 15 | 00 | | | | | | |

### Arthur Best

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | | | |
| *Jan.* | 2 | *Sales* | *J1* | 12 | 20 | | | | | | |

### Sales

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 19— | | | | | |
| | | | | | | *Jan.* | 2 | *Cash* | *J1* | 93 | 20 |
| | | | | | | | 2 | *A. Best* | *J1* | 12 | 20 |
| | | | | | | | 4 | *Cash* | *J1* | 102 | 20 |
| | | | | | | | 4 | *J. Moran* | *J1* | 18 | 42 |
| | | | | | | | 5 | *S. A. Atkins* | *J1* | 12 | 00 |
| | | | | | | | 5 | *Cash* | *J1* | 85 | 00 |
| | | | | | | | 6 | *Cash* | *J1* | 120 | 70 |
| | | | | | | | 7 | *Cash* | *J1* | 110 | 00 |

### Furniture and Fixtures

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | | | |
| *Jan.* | 2 | *Mentor Wh. Co.* | *J1* | 450 | 00 | | | | | | |

**Mentor Wholesale Company**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | 2 | *Furniture and Fixtures* ......... | *J1* | 450 00 |

**Supplies**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | 3 | *Cash* .......... | *J1* | 15 00 | | | | | |

**S. A. Atkins**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | 5 | *Sales* .......... | *J1* | 72 00 | | | | | |

**James Moran**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | 4 | *Sales* ........ . | *J1* | 18 42 | | | | | |

**Basic Nature of Rules.** The rules for debit and credit as stated, explained, and illustrated in this chapter are of fundamental importance. Unless their application to such illustrative transactions as are given above is understood, progress in the study of accounting is impossible. It is suggested, therefore, that this chapter be studied and reviewed until the significance of *debit* and *credit*, as these words are employed by accountants, is grasped fully. The student will do well to list as many transactions as he can think of as related to his own personal and business affairs, to journalize them, and in each instance write in the rule for debit or credit, as the case may be.

Later the application of these rules will be extended to adjustments of existing accounts.

# *Chapter* 5

# THE JOURNAL AND LEDGER

**Analysis of Transactions Reviewed.** If the student has carefully studied Chapter 4, he should have an understanding of the meaning of analysis as it applies to business transactions. As has been shown, the analysis of business transactions is covered by the rules of debit and credit. It has been shown that for each debit there is an equal corresponding credit. It also has been shown that after the analysis of a business transaction has been made it can be expressed in simple, but technical, form known as the journal entry. Journal entries are simply a convenient way of expressing the essential facts relative to the analysis of business transactions and, as will be shown later, relative to adjustments of various kinds.

It is natural that a business man should make the analysis of a transaction and he should also record this analysis in written form as soon as possible after the transaction has occurred. It is evident, therefore, that the record of transactions expressed in the form of journal entries will be a *chronological* record, that is, one in which the entries are made in the order in which they occur. In modern business, this record is known as the *Journal*, and when there is but one journal, as may be the case in small enterprises, it is known as the *General Journal*.

**General Journal Form.** In Fig. 45 is shown the standard form of the journal. This form is arranged for convenient entering of journal entries based on the analysis of transactions. Naturally, these entries are made in chronological order. Each entry in the journal should be followed by an explanation sufficiently detailed to enable one unfamiliar with the accounts to secure a clear understanding of each journal entry.

Some explanation of this form is in order. In this case, the title *General Journal* appears at the top. In practice, this might be followed by the name of the proprietor, or of the partnership, or

**General Journal**

| 19— | | | | Debits | | Credits | |
|---|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | | 6 | |
| *Jan.* | *7* | *Cash* . . . . . . . . . . . . . | *6* | *5,000* | *00* | | |
| | | *A. Morse, Net Worth* . . . . . . . . . . . . | *32* | | | *5,000* | *00* |
| | | *To begin business* | | | | | |
| | *2* | *Purchases* . . . . . . . . . . . . . . . . . . . . . . | *3* | *400* | *00* | | |
| | | *Cash* . . . . . . . . . . . . . . . . | *6* | | | *400* | *00* |
| | | *Merchandise bought for cash.* | | | | | |

Fig. 45

corporation, as the case may be. The numbers which appear at the top of each column do not appear in the standard journal form. They are used here only to aid reference. In column 1 should appear the abbreviation for the month. Immediately above this column should appear the year, as for example, 19—. It is unnecessary to repeat the abbreviation for the month, except when entries are begun at the top of another page of the journal. In column 2 is indicated the day of the month. In column 3, which is known sometimes as the *explanation* column, the debit and the credit together with the explanation applicable thereto are expressed. In column 4, which is known as the *folio* column, is indicated the page of the ledger to which the particular item is posted. This will be better understood after the student has completed the study of this chapter. For example, the $5,000.00 debit to cash is posted to page 6 of the ledger and the $5,000.00 credit to A. Morse, Net Worth, is posted to page 32 of the ledger. In column 5 debits are expressed and in column 6, credits. These are known frequently as the *debit* and *credit* columns, respectively.

There are some variations from the form shown in Fig. 45, but these are not material in case of a standard journal form. Sometimes, for example, it is desirable to express the date, January 1, in the center of the explanation column above the entry instead of writing it in the date column on the lefthand margin of the paper.

**Importance of Correct Journalizing.** Too great an emphasis cannot be placed upon the importance of correct journalizing. It is at this point that the analysis of the transaction is made. If it is made

incorrectly and entered incorrectly in the journal, it is almost certain to impair the basic statements which are made weeks or months later. The importance of an adequate explanation after each journal entry should also be emphasized. In practice, the explanation *to begin business* would ordinarily be insufficient. It is used in Fig. 45, since the purpose of this figure is simply to outline and make clear the use of the various journal columns. In practice, the explanation following the opening entry in the journal might be many lines in length. It might even contain historical data in the event that new books are being opened for an old business.

It will be seen later that the general journal may receive entries which are not the result of transactions, but are instead the reflection of adjustments, corrections, and transfers from one account to another. These also are of great importance and must be made with the same care and attention to detail that are used in connection with other journal entries.

Technically, journalizing consists simply in entering a transaction in the journal after it has been analyzed to determine what accounts must be debited and credited, respectively. The journal is a book of original entry. This means that transactions are entered in the journal first; later, as will be explained, postings are made to accounts kept in the ledger.

Usually a journal entry consists of one debit and one credit, and it is then known as a simple journal entry; but sometimes there may be one or more debits and one or more credits in a given journal entry, in which event it is known as a *compound* journal entry. An illustration of a compound journal entry would be the case of a sale of merchandise amounting to $800.00 to A. L. Bordner, one-half on account and one-half payable in cash. This entry would appear as follows:

| | | |
|---|---|---|
| *Cash* . . . | *400.00* | |
| *A. L. Bordner* . . . | *400.00* | |
| *Sales* | | *800.00* |
| *For sale of merchandise to A. L. Bordner, one-half cash, one-half on account, terms 2 per cent 10 days, net 30 days.* | | |

**Posting.** As already explained, the journal entries are made in chronological order and therefore these entries are not classified.

One entry may contain a debit to cash and a credit to sales, the next entry may contain a debit to purchases and a credit to cash, etc. It is evident that as the number of entries increases, great confusion results. It is necessary, therefore, to classify all debits and credits which appear in the journal. This classification is accomplished by a procedure known as posting, whereby the debits and credits appearing in the journal are made to appear in the ledger according to the account classification which has been adopted for the business in question. A rather detailed classification of accounts has already been given in Chapter 4. Of course, a classification of accounts must be adapted to the business in question. There is not available a completely standard classification of accounts. This is because each business possesses peculiarities not found in other businesses. However, one who has before him a fairly detailed classification of accounts may make the necessary changes to adapt the classification to a particular business.

The ledger is simply a book of accounts, each page being ruled similarly to the form shown on page 57. Frequently, the modern ledger is loose-leaf in form. In this event, there should appear but one account on each ledger sheet. If the ledger is a bound book, it may be possible to have two accounts on each page, but this is a matter which must be determined in view of the requirements.

Since the journal and ledger both contain folio columns, there exists a complete scheme of cross-reference between the two books. In the journal folio column is indicated the page of the ledger to which the item in question is posted. In the ledger folio column is indicated the page of the journal from which the item in question is posted. Consequently, one examining a ledger account can refer easily to the page of the journal from which any sum has been posted. Likewise, one examining the journal can note to which page of the ledger each item has been posted.

An illustration showing the use of the journal and ledger follows. Note that in this case each ledger account is supposed to occupy one page of the ledger. This page is indicated in the upper right-hand corner of each ledger account. Note that the page number of each ledger account appears in the Journal folio column.

## R. E. Myers

### JOURNAL

19— | | | 1

| | | | | | |
|---|---|---|---|---|---|
| *Jan.* | 1 | *Cash* | 1 | 2,500 00 | |
| | | *R. E. Myers* | 2 | | 2,500 00 |
| | | *For investment in retail merchandise business* | | | |
| | 1 | *Furniture and Fixtures* | 3 | 500 00 | |
| | | *Cash* | 1 | | 500 00 |
| | | *For purchase of furniture for store* | | | |
| | 1 | *Purchases* | 4 | 700 00 | |
| | | *Cash* | 1 | | 700 00 |
| | | *For purchase of merchandise for cash* | | | |
| | 1 | *Purchases* | 4 | 800 00 | |
| | | *Ansom Wholesale Company* | 5 | | 800 00 |
| | | *For purchase of merchandise on account, terms 2 per cent, 10 days, net 60 days* | | | |
| | 1 | *Rent Expense* | 6 | 70 00 | |
| | | *Cash* | 1 | | 70 00 |
| | | *For payment of rent for January* | | | |
| | 3 | *A. B. Grant* | 7 | 18 00 | |
| | | *Sales* | 8 | | 18 00 |
| | | *For sale of merchandise on account* | | | |
| | 4 | *Cash* | 1 | 72 90 | |
| | | *Sales* | 8 | | 72 90 |
| | | *For cash sales for day* | | | |
| | 5 | *L. S. Crow* | 9 | 14 30 | |
| | | *B. S. Smith* | 10 | 11 50 | |
| | | *Sales* | 8 | | 25 80 |
| | | *For sale of merchandise on account* | | | |
| | 5 | *Advertising Expense* | 11 | 8 00 | |
| | | *Cash* | 1 | | 8 00 |
| | | *For payment for advertising* | | | |
| | 6 | *Cash* | 1 | 81 00 | |
| | | *Sales* | 8 | | 81 00 |
| | | *For cash sales for day* | | | |
| | 7 | *Delivery Equipment* | 12 | 700 00 | |
| | | *Cash* | 1 | | 700 00 |
| | | *For purchase of delivery truck* | | | |
| | 7 | *Cash* | 1 | 76 40 | |
| | | *Sales* | 8 | | 76 40 |
| | | *For cash sales for day* | | | |
| | 7 | *Sales Returned* | 13 | 2 00 | |
| | | *A. B. Grant* | 7 | | 2 00 |
| | | *For defective merchandise returned* | | | |

**Cash**

| 19— | | | | | | 19— | | | | | 1 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *R. E. Myers* | *J1* | *2,500* | *00* | *Jan.* | *1* | *Furniture and Fixtures* | *J1* | *500* | *00* |
| | *4* | *Sales* | *J1* | *72* | *90* | | *1* | *Purchases* | *J1* | *700* | *00* |
| | *6* | *Sales* | *J1* | *81* | *00* | | *1* | *Rent* | *J1* | *70* | *00* |
| | *7* | *Sales* | *J1* | *76* | *40* | | *5* | *Advertising Expense* | *J1* | *8* | *00* |
| | | *752.30* | | | | | *7* | *Delivery Equipment* | *J1* | *700* | *00* |

**R. E. Myers**

| | | | | | | 19— | | | | | 2 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | *Jan.* | *1* | *Cash* | *J1* | *2,500* | *00* |

**Furniture and Fixtures**

| 19— | | | | | | | | | | | 3 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Cash* | *J1* | *500* | *00* | | | | | | |

**Purchases**

| 19— | | | | | | | | | | | 4 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Cash* | *J1* | *700* | *00* | | | | | | |
| | *1* | *Ansom Wholesale Co.* | *J1* | *800* | *00* | | | | | | |
| | | *1,500.00* | | | | | | | | | |

**Ansom Wholesale Company**

| | | | | | | 19— | | | | | 5 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | *Jan.* | *1* | *Purchases* | *J1* | *800* | *00* |

**Rent Expense**

| 19— | | | | | | | | | | | 6 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Cash* | *J1* | *70* | *00* | | | | | | |

**A. B. Grant**

| 19— | | | | | | 19— | | | | | 7 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *3* | *Sales* | *J1* | *18* | *00* | *Jan.* | *7* | *Sales returned* | *J1* | *2* | *00* |

**Sales**

| 19— | | | | | | 19— | | | | | 8 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | *Jan.* | 3 | *A. B. Grant* | *J1* | 78 | 00 |
| | | | | | | | 4 | *Cash.* | *J1* | 72 | 90 |
| | | | | | | | 5 | *L. S. Crow* | *J1* | 14 | 30 |
| | | | | | | | 5 | *B. S. Smith.* | *J1* | 11 | 50 |
| | | | | | | | 6 | *Cash..* | *J1* | 81 | 00 |
| | | | | | | | 7 | *Cash....* 274.10 | *J1* | 76 | 40 |

**L. S. Crow**

| 19— | | | | | | | | | | | 9 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 5 | *Sales..........* | *J1* | 14 | 30 | | | | | | |

**B. S. Smith**

| 19— | | | | | | | | | | | 10 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 5 | *Sales .......* | *J1* | 11 | 50 | | | | | | |

**Advertising Expense**

| 19— | | | | | | | | | | | 11 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 5 | *Cash..........* | *J1* | 8 | 00 | | | | | | |

**Delivery Equipment**

| 19— | | | | | | | | | | | 12 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 7 | *Cash... .....* | *J1* | 700 | 00 | | | | | | |

**Sales Returned**

| 19— | | | | | | | | | | | 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 7 | *A. B. Grant .* | *J1* | 2 | 00 | | | | | | |

**Trial Balance.** The student should examine carefully the preceding illustrations. He should note how each debit and each credit appearing in the journal of R. E. Myers is posted to the proper account in the ledger. Since each journal entry contains equal debits and credits, and since debits in the journal become debits in the

ledger, it is evident that the equality of debits and credits is preserved in the ledger. This is a fact of fundamental importance, because it makes possible an important check on the accuracy of the work done in the form of what is known as a *Trial Balance.*

The trial balance may be either a trial balance of totals or a trial balance of balances. In Fig. 46 is shown a trial balance of totals. In Fig. 47 is shown a trial balance of balances. Note that in both trial balances the total of the debits is equal to the total of the credits. This should be the case because of the equality of the debits and credits in the ledger accounts. The only difference between a trial balance of totals and a trial balance of balances is that in case of the latter equal amounts have been eliminated from both sides of certain accounts. For example, in case of the Cash account, the balance is shown as \$752.30. In other words, \$1,978.00 is eliminated from both sides of the Cash account. Obviously, when equal sums are eliminated on both debit and credit side of ledger accounts, the balances of all ledger accounts will still show equality of debits and credits.

In practice the trial balance of balances is the one used. It serves the two fundamental purposes of a trial balance, namely: (*a*) a check on work already done; (*b*) a basis of interpretation.

The check afforded by the trial balance, on work already done, is not absolute proof that no errors have been made. It is simply proof that the equality of debits and credits which exists in the journal also exists in the ledger. If any item, either debit or credit, found in the journal is not posted, the trial balance totals will not be equal in amount. On the other hand, if an item in the journal is posted to the wrong ledger account, but on the proper side, debit or credit, as the case may be, the trial balance totals will be equal. For example, if the item of \$72.90, which appears on the debit side of the Cash account, had been posted erroneously to the Furniture and Fixtures account, the balance of cash would be \$72.90 less, and the balance of Furniture and Fixtures would be \$72.90 more. Since these are both debit balances, the total of the debit column of the trial balance would still be \$3,574.10, as shown in Fig. 47. Notwithstanding these limitations on the trial balance, as a check on work done, it is extremely important.

An equally important use of the trial balance is to serve as a basis for interpreting the accounts. This process of interpretation will be explained in chapters that follow.

**R. E. Myers**

TRIAL BALANCE OF TOTALS

**January 7, 19—**

| | Debit | Credit |
|---|---|---|
| *Cash* | *2,730.30* | *1,978.00* |
| *R. E. Myers* | | *2,500.00* |
| *Furniture and Fixtures* | *500.00* | |
| *Purchases* | *1,500.00* | |
| *Ansom Wholesale Company* | | *800.00* |
| *Rent Expense* | *70.00* | |
| *A. B. Grant* | *18.00* | *2.00* |
| *Sales* | | *274.10* |
| *L. S. Crow* | *14.30* | |
| *B. S. Smith* | *11.50* | |
| *Advertising Expense* | *8.00* | |
| *Delivery Equipment* | *700.00* | |
| *Sales Returned* | *2.00* | |
| | *5,554.10* | *5,554.10* |

Fig. 46

**R. E. Myers**

TRIAL BALANCE OF BALANCES

**January 7, 19—**

| | Debit | Credit |
|---|---|---|
| *Cash* | *752.30* | |
| *R. E. Myers* | | *2,500.00* |
| *Furniture and Fixtures* | *500.00* | |
| *Purchases* | *1,500.00* | |
| *Ansom Wholesale Company* | | *800.00* |
| *Rent Expense* | *70.00* | |
| *A. B. Grant* | *16.00* | |
| *Sales* | | *274.10* |
| *L. S. Crow* | *14.30* | |
| *B. S. Smith* | *11.50* | |
| *Advertising Expense* | *8.00* | |
| *Delivery Equipment* | *700.00* | |
| *Sales Returned* | *2.00* | |
| | *3,574.10* | *3,574.10* |

Fig. 47

# *Chapter* 6

# MIXED ACCOUNTS AND ADJUSTING ENTRIES

**Mixed Accounts.** An examination of the classification of accounts given in Chapter 4 shows the following general divisions: (1) Asset accounts, (2) Liability accounts, (3) Net Worth accounts, (4) Expense accounts, (5) Revenue accounts.

It now is necessary to note that in some instances accounts listed as assets may contain expense elements. This means that the account is no longer strictly an asset account; that is, part of the balance of the account represents an asset and part of it represents an expense.

This is a situation which inevitably arises because of the way in which accounts must be kept. On the other hand, it is a situation which must be remedied before the results for the period can be determined. The elements which comprise the balance of mixed accounts must be separated in order to determine what the true expense of operations is for the accounting period.

Just as accounts which are primarily asset accounts may contain expense elements, likewise accounts which are primarily expense accounts may contain asset elements. The same comments which have been made above, relating to asset accounts which contain expense elements, apply to expense accounts which contain asset elements.

**The Purchases Account.** If all merchandise purchased during the accounting period were still on hand at the close of the period, it is evident that no sales could have occurred, and that the entire amount of purchases would remain an asset. By the very nature of business, however, this would not occur, because sales are made throughout the accounting period as well as purchases; so that it is evident that if a concern begins business on January 1 and purchases a total of $10,000.00 worth of merchandise during the month of January, only a portion of this merchandise will be on hand, January 31. For purposes of illustration, assume that the Purchases

account at the close of business, on January 31, appears as shown in Fig. 48.

**Purchases**

| 19— | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1–31* | | | *10,000* | *00* | | | | |

Fig. 48

Assume, further, that during the month sales amount to $8,000.00 and that the cost of the goods sold is $6,000.00. It is evident that of the $10,000.00 purchases, only $4,000.00 remains on hand, since $6,000.00 of purchases have been sold for $8,000.00.

In practice, the cost of goods sold is found at the end of the accounting period by determining, first, the amount of goods still on hand taken at cost price. Thus, if an actual count shows that the merchandise on hand on January 31 amounts to $4,000.00, taken at cost, the cost of goods sold is determined by the procedure indicated in Fig. 49.

| | |
|---|---|
| *Purchases* . . . . . . . . . . . . | *10,000.00* |
| *Less Inventory Jan. 31, 19—*. | *4,000.00* |
| *Cost of Goods Sold* . . . . . . . | *6,000.00* |

Fig. 49

Carrying the illustration one step farther, assume that during February purchases amount to $9,000.00, and that merchandise on hand at the end of February amounts to $3,500.00. In this case, it is necessary to take into account the inventory on hand on February 1, as well as the inventory on hand on February 28, in order to determine the cost of goods sold. This is accomplished as shown in Fig. 50.

| | |
|---|---|
| *Inventory Feb. 1, 19—*. | *4,000.00* |
| Add *Purchases*. . . . . | *9,000.00* |
| | *13,000.00* |
| Less *Inventory Feb. 28, 19—*. | *3,500.00* |
| *Cost of Goods Sold* . . . . . . . . | *9,500.00* |

Fig. 50

This same result can be determined by making certain adjustments in the ledger accounts. In order to indicate the procedure, it

is necessary to cover both January and February. The Purchases account at the end of January stands as shown in Fig. 51.

**Purchases**

| 19— | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1–31* | | | *10,000* | *00* | | | | | |

Fig. 51

Since the inventory on January 31 is $4,000.00, this represents the asset portion of the $10,000.00 in the Purchases account. By means of what is known as an adjusting journal entry, this is transferred to the Inventory account as follows:

| | *January 31* | |
|---|---|---|
| *Inventory* | *4,000.00* | |
| *Purchases* | | *4,000.00* |
| *To set up closing inventory.* | | |

The cost of goods sold is carried to a Cost of Goods Sold account, as follows:

| | | |
|---|---|---|
| *Cost of Goods Sold* | *6,000.00* | |
| *Purchases* | | *6,000.00* |
| *To carry cost of goods sold to Cost of Goods Sold account.* | | |

When the foregoing journal entries are posted, the ledger accounts involved appear as shown in Fig. 52.

**Purchases**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1–31* | *Cash, etc.* | | *10,000* | *00* | *Jan.* | *31* | *Inventory* | *J10* | *4,000* | *00* |
| | | | | | | | *31* | *C.G.S.* | *J10* | *6,000* | *00* |
| | | | | *10,000* | *00* | | | | | *10,000* | *00* |

**Inventory**

| 19— | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *31* | *Purchases* | *J10* | *4,000* | *00* | | | | | | |

**Cost of Goods Sold**

| 19— | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *31* | *Purchases* | *J10* | *6,000* | *00* | | | | | | |

Fig. 52

The balance of the Purchases account, \$6,000.00, represents the cost of goods sold and the amount of goods on hand is \$4,000.00, as shown in the inventory account.

Continuing with the accounts for February, the purchases amount to \$9,000.00, and on February 28 the Purchases account stands as shown in Fig. 53.

**Purchases**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1–31* | *Cash, etc.* | | *10,000 00* | *Jan.* | *31* | *Inventory* | *J10* | *4,000 00* |
| | | | | | | *31* | *C. G. S.* | *J10* | *6,000 00* |
| | | | | *10,000 00* | | | | | *10,000 00* |
| *Feb.* | *1–28* | *Cash, etc.* | | *9,000 00* | | | | | |

Fig. 53

The inventory on February 28 amounts to \$3,500.00. In order to show the cost of goods sold in the Purchases account, it is necessary to make two adjusting journal entries, as follows:

| | | |
|---|---|---|
| | *February 28* | |
| *Purchases* | *4,000.00* | |
| *Inventory* | | *4,000.00* |
| *To carry opening inventory to Purchases account.* | | |
| | *February 28* | |
| *Inventory* | *3,500.00* | |
| *Purchases* | | *3,500.00* |
| *To set up closing inventory.* | | |

The cost of goods sold is carried to Cost of Goods Sold account by means of the following entry.

| | | |
|---|---|---|
| *Cost of Goods Sold* | *9,500.00* | |
| *Purchases* | | *9,500.00* |
| *To carry cost of goods sold to Cost of Goods Sold account.* | | |

The accounts now stand as shown in Fig. 54.

The student should study carefully the accounts shown in Fig. 54. If he secures a thorough understanding of these accounts and the journal entries from which the items are posted, he will have accomplished much toward the understanding of mixed accounts and the adjustments which they must undergo. A review of the procedure is therefore in order. Note that during January, purchases for cash and on account amounted to \$10,000.00. This is shown in the

**Purchases**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1–31* | *Cash, etc.* | | *10,000* | *00* | *Jan.* | *31* | *Inventory* | *J10* | *4,000* | *00* |
| | | | | | | | *31* | *C.G.S.* | *J10* | *6,000* | *00* |
| | | | | *10,000* | *00* | | | | | *10,000* | *00* |
| *Feb.* | *1–28* | *Cash, etc.* | | *9,000* | *00* | *Feb.* | *28* | *Inventory* | *J22* | *3,500* | *00* |
| | *28* | *Inventory* | *J22* | *4,000* | *00* | | *28* | *C.G.S.* | *J22* | *9,500* | *00* |
| | | | | *13,000* | *00* | | | | | *13,000* | *00* |

**Inventory**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *31* | *Purchases* | *J10* | *4,000* | *00* | *Feb.* | *28* | *Purchases* | *J22* | *4,000* | *00* |
| *Feb.* | *28* | *Purchases* | *J22* | *3,500* | *00* | | | | | | |

**Cost of Goods Sold**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *Purchases.* | *J10* | *6,000* | *00* | *Jan.* | *Profit and Loss.* | *J20* | *6,000* | *00* |
| *Feb.* | *Purchases.* | *J22* | *9,500* | *00* | *Feb.* | *Profit and Loss.* | *J22* | *9,500* | *00* |

Fig. 54

first entry on the debit side of the Purchases account. At the end of January, there remained on hand an inventory of merchandise of $4,000.00. As shown in preceding calculations, this inventory of $4,000.00, when deducted from the purchases of January, gives $6,000.00 as the cost of goods sold for January. This item of cost of goods sold is expressed in the Purchases account as C.G.S.

At times it is necessary to transfer items from one account to another. This is illustrated in the case of the $4,000.00 inventory, as at January 31. The $4,000.00 is credited to Purchases account and debited to the Inventory account. The journal entry which illustrates this is shown on page 81. The remaining $6,000.00 in the Purchases account on January 31 is transferred to the Cost of Goods Sold account as shown on page 81.

At the beginning of February there is no balance in the Purchases account. This account has been ruled up and the total of each side shown below the single ruling. Underneath each total of $10,000.00 is placed a double ruling. This ruling up of accounts is a procedure of considerable importance. It is done whenever a point is reached where it is desirable to indicate that the account is either

closed or that it is desirable to carry the balance of the account to another account or simply to carry the balance down in the same account. In the Purchases account there remains no balance after the $4,000.00 has been transferred to the Inventory account and after the $6,000.00 has been transferred to the Cost of Goods Sold account. In a sense, however, it may be said that the balance of the account, namely, $6,000.00, is transferred to the Cost of Goods Sold account. At any rate the two sides of the Purchases account are equal and the account is closed by the rulings shown. An account may be ruled up and the balance brought down at any time. An illustration of this is given in Fig. 55. Here the Cash account of R. E. Myers is ruled up and the balance brought down. This should be compared with the Cash account shown on page 75.

**Cash**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *R. E Myers* | *J1* | 2,500 | 00 | *Jan* | *1* | *Furniture and Fixtures* | *J1* | 500 | 00 |
| | *4* | *Sales* | *J1* | 72 | 90 | | *1* | *Purchases* | *J1* | 700 | 00 |
| | *6* | *Sales* | *J1* | 81 | 00 | | *1* | *Rent* | *J1* | 70 | 00 |
| | *7* | *Sales* | *J1* | 76 | 40 | | *5* | *Advertising Expense* | *J1* | 8 | 00 |
| | | | | | | | *7* | *Delivery Equipment* | *J1* | 700 | 00 |
| | | | | | | | *7* | *Balance* | | 752 | 30 |
| | | | | 2,730 | 30 | | | | | 2,730 | 30 |
| | *8* | *Balance* | | 752 | 30 | | | | | | |

Fig 55

During February, purchases amounted to $9,000.00, as shown in Purchases account. At the end of February, in order to find the cost of goods sold, it is necessary to transfer the inventory of $4,000.00 back to the debit side of Purchases account. This is accomplished by means of the journal entry shown on page 82. As a result, the Inventory account is closed and this is indicated by the single ruling underneath the debit item of $4,000.00 and underneath the credit item of $4,000.00. The Purchases account now contains two debits, namely, $9,000.00 and $4,000.00, a total of $13,000.00 to be accounted for. As stated, the inventory on February 28 is $3,500.00. This is the closing inventory, and by means of

the entry shown on page 82 it is credited to the Purchases account and debited to the Inventory account. The cost of goods sold is found to be $9,500.00. This may be carried to the Cost of Goods Sold account by means of the journal entry shown on page 82. When this is done, the Purchases account is again ready to be ruled up as shown in Fig. 54. The manner in which the item of $6,000.00 is carried to the Profit and Loss account at the end of January and the $9,500.00 is carried to Profit and Loss at the end of February will be explained later.

The procedure in connection with the Purchases account, Inventory account, and Cost of Goods Sold account described above is repeated each month. In the procedure described, the balance in the Inventory account is transferred back to the debit side of the Purchases account at the end of the month. It is equally correct to transfer the balance of the Inventory account at the beginning of the month, as it makes no difference in the final result.

**Fixed Asset Accounts.** Fixed assets include such items as land, buildings, delivery equipment, and furniture and fixtures. With the exception of land, these items are subject to depreciation. In a sense the purchase of buildings, furniture and fixtures, and delivery equipment is the prepayment of an expense, since the cost of such assets must be amortized, or written off, during their useful life. It is only because of the relative permanence of these assets that they are called assets instead of being called prepaid expenses. Nevertheless, in the accounts they must be treated as long-term prepaid expenses; otherwise, serious error is certain to arise at each accounting period in the determination of true net profit.

To illustrate, take the case of a building which costs $10,000.00 and which has an estimated useful life of 20 years, and an estimated salvage value of zero. Since this building is used to promote operations, it is evident that each year there occurs an expense of approximately $500.00, as a result of such use. This amount is obtained by dividing the cost of the building, $10,000.00, by its estimated useful life, namely, 20 years. This expense is known as depreciation. It is an expense which applies to each year, or each accounting period, even though no expenditure of money occurs each year. In reality, the expenditure occurred at the beginning of the 20-year period. To

continue carrying the building, as an asset worth $10,000.00, results in an overstatement of the value of the building and also results in an overstatement of net profit for each year.

It is therefore necessary at the end of each accounting period, that is, at the end of each month or year, as the case may be, to make an adjusting entry which will result in a charge to Depreciation Expense account for the amount of depreciation applicable to such a period. Assuming that the accounting period is one year, the charge at the end of the first year for depreciation is $500.00. This entry may be made as follows:

| | | |
|---|---|---|
| *Depreciation Expense.* . . . . | *500 00* | |
| *Building* . . . . . | | *500 00* |
| *For depreciation for the year.* | | |

After this journal entry is posted, the ledger accounts for the Building and for Depreciation Expense stand as shown in Fig. 56.

**Building**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | | | *10,000 00* | *Dec.* | *31* | *Depreciation Expense* . . | *J10* | *500 00* |

**Depreciation Expense**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | *31* | *Building* . | *J10* | *500 00* | | | | | |

Fig. 56

The foregoing procedure results in the annual reduction of the balance in the Building account by $500.00. This is entirely correct, but it has been found in practice that it is desirable to show the balance in the Building account at original cost throughout the life of the building. The importance of so doing has led to a modification of the procedure, which will now be illustrated. Instead of the journal entry shown above, the following journal entry is made.

| | | |
|---|---|---|
| * *Depreciation Expense* . . . . . . . . . . . . . . . . . . . . . . . . . | *500.00* | |
| *Reserve for Depreciation* . . . . . . . . . . . . . . . . . . . . . . . | | *500 00* |
| *For depreciation for the year.* | | |

After this entry is posted, the amounts involved appear as shown in Fig. 57.

**Building**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan* | *1* | | | *10,000 00* | | | | | |

**Reserve for Building Depreciation**

| | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | *Dec* | *31* | *Depreciation Expense......* | *J10* | *500 00* |

**Building Depreciation Expense**

| 19— | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | *31* | *Reserve for Depreciation* | *J10* | *500 00* | | | | | |

Fig. 57

The Reserve for Depreciation account to which the credit item of $500.00 is posted is known as a valuation account. In other words, the assumed decline in value of a building is recorded, not in the Building account, but in the Reserve for Depreciation account. The Depreciation Expense account is the same as in Fig. 56. There are various ways of expressing the relationship which exists between the Building account and the Reserve for Depreciation account applicable thereto. It may be said that the accrued depreciation on the building amounts to $500.00, or it may be said that the original cost of the building, which is $10,000.00, less the accrued depreciation of $500.00, gives a present book value of $9,500.00. The point is that the Reserve for Depreciation account must be considered in connection with the Building account in order to determine what is the book value of the building. As will be shown in later illustrations, the custom is to show the reserve for depreciation deducted from the original cost of the building on the asset side of the balance sheet, as follows:

| | | |
|---|---|---|
| *Building* . . | *10,000.00* | |
| *Less Reserve for Depreciation* . . . . . . . . . . . | *500.00* | *9,500.00* |

Some business concerns still follow the practice of setting up but one Reserve for Depreciation account; but with the desire for more detailed information relative to accrued depreciation on fixed

assets, it is becoming the practice to carry a reserve for each significant asset. It is obviously desirable that separate depreciation reserves be set up for such important assets as buildings, furniture and fixtures, and delivery equipment. The ultimate disposition of the amount shown in the Depreciation Expense account will be explained later. It is sufficient to note at this point that after the adjustment for depreciation for the current period has been made the expense element has been transferred to a separate account, namely, the Depreciation Expense account. It is only by thus segregating the expense element in the building in a separate account that it is possible to secure accurate information relative to all items of expense for the current accounting period. It may be noted that just as depreciation expense is the expense which accrues in connection with the use of the building, so cost of goods sold is an expense incurred in order to secure revenue from sales.

The procedure for setting up Depreciation Expense accounts and Depreciation Reserve accounts in connection with other fixed assets is essentially the same as that explained above.

It may be well to emphasize the fact that these adjusting entries are made at the end of the accounting period in order that accurate information may be secured relative to all items of income and all items of expense.

**Accounts Receivable.** In modern business, credit plays an important part. It sometimes takes the form of notes and trade acceptances which will be explained later. Frequently, it takes the form of open accounts receivable and open accounts payable. From the point of view of a given enterprise, the sum of the amounts owed the enterprise by its customers is known as the total of its *accounts receivable*, and the sum of the amounts which it owes its creditors is known as its *accounts payable*.

It is evident that even though great care is exercised in the selection of customers, some losses will occur due to the uncollectibility of some accounts. If customers' accounts are payable within 30 days, it is evident that at any particular time the total of outstanding but uncollected accounts receivable should represent not more than one month's sales on account. In such a case, it may be said that the accounts receivable are collected or turned over twelve times each

year. In practice, however, owing to the slowness with which some customers pay, it is found that there is a tendency for the accounts receivable to accumulate to an amount greater than the terms of sale would indicate. In other words, if an analysis is made at a given time of all open accounts receivable, it may be found that some are past due for a considerable period of time, while others are so long past due that their collection is hopeless. It is for this reason that business men speak of accounts receivable as being good, doubtful, and bad.

If sales on account in January amount to $40,000.00, most of this will have been collected by the end of February, but certain accounts will remain open. During March many of these remaining items will be collected, and similarly during the following months further collections will be made on past due accounts which were opened in January. By the end of the year, accounts opened in January and still uncollected may be regarded as definitely bad accounts. The same situation will arise in connection with the sales on credit for February, March, April, and following months. It is evident that on December 31 it would be impossible to determine all specific items arising from sales made during the year which will prove to be uncollectible. It is also evident, however, that the uncollectible items arising out of the credit sales for the year represent an expense applicable to the current year. In other words, all bad debts arising out of the current year's credit sales are expenses which should be taken into account in an attempt to compute the current year's net profit.

In connection with the accounting for accounts receivable, it is evident that the expense arising out of bad debts must be accounted for in either of two ways, namely: (*a*) Individual customers accounts shall be written off, i.e., treated as expense, when definitely ascertained to be uncollectible. (*b*) An estimate shall be made at the end of the accounting period of the amount of uncollectible customers' accounts applicable to that period.

*a*) This first plan was formerly widely used, but it is subject to the objection that the expense arising from the uncollectibility of a particular account cannot usually be determined until after the close of the accounting period in which the sale was made. For

example, on September 5, a concern sells \$20.00 worth of merchandise to S. R. Borden and on December 31 of the same year Borden still owes this amount. It is probably impossible at this date to determine whether the account is collectible or not. This means that it will be carried as an asset in the balance sheet at December 31. If on June 1 of the following year Borden's account is definitely ascertained to be bad, it will be treated as an expense, not of the year in which the sale was made, but of the year in which the uncollectibility of the account is ascertained. It is evident that this shifts expense into the wrong period. The bad debts which result from sales made in a given year are obviously expenses applicable to that year, not to following years. Therefore, under this first method of accounting for bad debts there is a constant lag which should not exist.

*b*) Under the second plan proposed, an estimate is made at the end of the accounting period of the amount of bad debts which will result from the year's sales. There are various ways in which this estimate may be made. It may be based on a percentage of the outstanding accounts receivable at the end of the year, or it may be based on a percentage of the total sales for the year. It may be based on an analysis of these accounts, such analysis being a subdivision of the accounts receivable on the basis of their age. Each enterprise must follow in this respect whatever plan seems most desirable.

To illustrate the procedure under (*b*), assume that John R. Morris has on his books on December 31 accounts receivable amounting to \$100,000.00, and that his business has been in existence for one year. Morris estimates that of this \$100,000.00, \$1,000.00 will prove to be uncollectible, but of course is unable, as yet, to determine which of the customers' accounts will prove uncollectible. The Accounts Receivable account is therefore a mixed account. Of the total, \$99,000.00 is an asset element and \$1,000.00 is an expense element. Following recognized accounting procedure, the following adjusting entry is made on Morris' books:

| | | |
|---|---|---|
| *Bad Debts Expense* | *1,000.00* | |
| *Reserve for Bad Debts* | | *1,000.00* |
| *To set up a reserve of 1 per cent of accounts receivable as at December 31.* | | |

The Reserve for Bad Debts account performs much the same function as does the Reserve for Depreciation account, that is, it evaluates, or helps to determine the value of the asset to which it relates, namely, accounts receivable. Just as the debit to the Depreciation Expense accounts brings upon the books the current depreciation expense, so the debit to Bad Debts Expense account brings upon the books at the proper time the expense resulting from uncollectible accounts. On the balance sheet, the reserve for bad debts is deducted from the accounts receivable in order to show, as correctly as possible, the book value of the accounts receivable, as follows:

| | | |
|---|---|---|
| *Accounts Receivable* .................................. | *100,000.00* | |
| *Less Reserve for Bad Debts*............................ | *1,000.00* | *99,000.00* |

At this point, it may be noted that there is some difference in the ultimate disposition of the two kinds of reserves which have been explained. The Reserve for Depreciation increases in amount throughout the life of the asset which it evaluates. On the other hand, a reserve for bad debts does not continue to increase, but is ordinarily reduced during the following year or so by being debited for the amount of customers' accounts actually ascertained to be bad. For example, suppose that during the year immediately following that for which the reserve for bad debts shown above is established, N. S. Butler's account of $44.10 is ascertained to be uncollectible. It is written off, or debited against the Reserve for Bad Debts, by means of the following entry:

| | | |
|---|---|---|
| *Reserve for Bad Debts*.............................. | *44.10* | |
| *Accounts Receivable, N. S. Butler*.. . . ..... | | *44.10* |
| *To carry uncollectible account to Reserve for Bad Debts.* | | |

Through other similar debits the credit in the Reserve for Bad Debts account may be largely or entirely eliminated within the following year.

**Accrued Expenses and Incomes.** The passing of time is the true measure of the amount of many items of expense and of certain items of income. To illustrate, if one borrows money on January 1 for one year, it is evident that interest expense accrues each day of the year and the amount accrued for each day is the same as the

amount accrued for any other day in the year, assuming that the amount of the loan remains unchanged. As a further illustration of the principle of accrual, assume that one owns a $1,000.00 bond which bears interest at 6 per cent payable March 1 and September 1. Although the owner receives $30.00 interest on March 1 and $30.00 on September 1, this income is not earned on these two days, but accrues during the preceding 6-month periods. Thus, it may be said that on December 31, 4 months' interest income has accrued, although it is not payable until March 1. Likewise, it may be said that interest accrues by equal daily amounts from March 1 to and including August 31, although it falls due and is payable on September 1.

Another illustration of accrued income would be the case in which a man rents a machine and collects the rent at the end of each 6-month period. Assuming that the rent for the 6-month period is $60.00, it is evident that at the end of the first month $10.00 of rental income has accrued in favor of the owner of the machine and that during each of the five months $10.00 additional rent will accrue, although the entire sum of $60.00 falls due and is payable at the end of the 6-month period. Should the owner of the machine wish to determine his income for an accounting period closing, say, 4 months after the machine is rented, it would be necessary for him to make an adjusting entry for the 4 months' accrued rental income.

Illustrations of adjustments required for accruing expenses will be given for (1) interest expense, (2) rent expense, (3) taxes expense.

*1. Interest Expense.* Assume that S. B. North owes a $10,000.00 mortgage on his business property. Assume further that the interest on this mortgage is at 6 per cent, payable semiannually, September 1 and March 1. North's accounting period is the year ending December 31. It is evident that if North desires an accurate statement of all expenses for the year ending December 31, he must take into consideration the fact that interest has accrued on the mortgage since September 1, although it is not payable until March 1. Four months' interest on $10,000.00 at 6 per cent amounts to $200.00. This is an expense applicable to the year ending December 31. For this amount there is also an unmatured liability of $200.00.

Therefore North should make the following adjusting entry on December 31:

| | December 31 | | |
|---|---|---|---|
| *Interest Expense* | | 200 00 | |
| *Interest Accrued* | | | 200 00 |
| *To show interest accrued on mortgage of $10,000 00 at 6 per cent for 4 months, also to show corresponding liability* | | | |

As will be explained later, the interest expense of $200.00 is transferred from the Interest Expense account to the Profit and Loss account, which is an account temporarily opened on the books at the close of the accounting period for the purpose of summarizing all items of income and all items of expense for the period. This procedure whereby balances in accounts, representing incomes and expenses, are transferred to Profit and Loss is known as *closing the books*. As indicated, this will be explained fully later. After the books are closed, what is known as a *post-closing entry* must be made in connection with the adjusting entry shown above. This post-closing entry is simply a reversal of the adjusting entry, as follows:

| | January 1 | | |
|---|---|---|---|
| *Interest Accrued* | | 200.00 | |
| *Interest Expense* . . . | | | 200 00 |
| *To reverse adjusting entry for interest accrued on mortgage.* | | | |

The accounts for interest expense and interest accrued now stand as shown in Fig. 58A.

**Interest Expense**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | 31 | *Interest Accrued* | *J40* | 200 00 | *Dec.* | 31 | *Profit and Loss* | *J41* | 200 00 |
| | | | | | *Jan.* | 1 | *Interest Accrued* . . | *J42* | 200 00 |

**Interest Accrued**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | 1 | *Interest Expense* | *J42* | 200 00 | *Dec* | 31 | *Interest Expense* | *J40* | 200 00 |

Fig. 58A

Note that the Interest Accrued account is closed. It was necessary to show the liability therefor only as at December 31, which is the date on which North prepares his balance sheet. The credit of $200.00 in the Interest Expense account requires explanation.

When North pays interest for 6 months on March 1, the amount of $300.00 will be charged to the Interest Expense account which will leave a debit balance in the Interest Expense account of $100.00. This is the amount of interest applicable to January and February, the first two months of the new accounting period. The payment of this interest may be shown in journal entry form as follows:

| | | |
|---|---|---|
| *Interest Expense* | *300.00* | |
| *Cash* | | *300.00* |
| *For payment of interest on mortgage at 6 per cent.* | | |

The Interest Expense account now stands as shown in Fig. 58B.

**Interest Expense**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | *31* | *Interest Accrued* | *J40* | *200 00* | *Dec.* | *31* | *Profit and Loss* | *J41* | *200 00* |
| *Mar* | *1* | *Cash* | | *300 00* | *Jan.* | *1* | *Interest Accrued* | *J42* | *200 00* |

Fig. 58B

2. *Rent Expense.* Assume that S. B. North rents a building at a monthly rental of $20.00, which he pays at the end of each 6-month period, rent being payable on October 1 and April 1. Since North's accounting period closes on December 31, there will be 3 months' rent accrued on that date and there will be a liability accrued therefor of $60.00. The following adjusting entry is required on December 31.

*December 31*

| | | |
|---|---|---|
| *Rent Expense* | *60.00* | |
| *Rent Accrued* | | *60.00* |
| *To show Rent Accrued and corresponding liability.* | | |

As was done in the case of Interest Expense, the $40.00 is transferred from the Rent Expense account to the Profit and Loss account in the process of closing the books. After the books are closed, the following post-closing entry is made:

*January 1*

| | | |
|---|---|---|
| *Rent Accrued* | *60.00* | |
| *Rent Expense* | | *60.00* |
| *To reverse adjusting entry for Rent Accrued.* | | |

The accounts for Rent Expense and Rent Accrued now stand as shown in Fig. 59.

**Rent Expense**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | *31* | *Rent Accrued* . | *J40* | *60* | *00* | *Dec.* | *31* | *Profit and Loss* | *J41* | *60* | *00* |
| | | | | | | *Jan.* | *1* | *Rent Accrued* . . . | *J42* | *60* | *00* |

**Rent Accrued**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Rent Expense* . . | *J42* | *60* | *00* | *Dec.* | *31* | *Rent Expense*. . . . | *J40* | *60* | *00* |

Fig. 59

When North pays $120.00 rent for 6 months on April 1, there will be a debit balance in the Rent Expense account of $60.00 which is the amount applicable to the period January 1 to April 1.

*3. Taxes Expense.* Taxes are treated somewhat differently. Taxes accrue usually on the basis of a calendar year and are payable sometime during the following year. The taxpayer is unable to tell the exact amount of his taxes until he receives his bill. Therefore he is required to estimate the amount of taxes accrued. If the month is the accounting period and if it be assumed that the estimated amount of taxes for one month is $12.00, the following entry is in order on the last day of each month.

| | | |
|---|---|---|
| *Taxes Expense* . . . . . . . . . . . . . . . . . . . | *12.00* | |
| *Taxes Accrued* . . . . . . . . . . . . . | | *12.00* |
| *For estimated taxes expenses for month.* | | |

If the year is the accounting period, the adjusting entry in order on December 31 is as follows:

| | | |
|---|---|---|
| *Taxes Expense* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *144.00* | |
| *Taxes Accrued* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *144.00* |
| *For estimated taxes for year.* | | |

In either event, the Taxes Expense account will be debited for the total of $144.00 for the year and the Taxes Accrued account will represent a liability of $144.00 on December 31.

Assuming that when the tax bill is received on March 16 the amount of the tax is shown to be $160.00, the following entry is required.

*March 16*

| | | |
|---|---|---|
| *Taxes Accrued* | *144 00* | |
| *S B North, Net Worth* | *16 00* | |
| *Cash* | | *160 00* |
| *For payment of taxes The excess of the tax over the amount estimated is charged to North's Net Worth account* | | |

**Accrued Income.** One illustration, namely, interest, will be used to illustrate the principles which apply to accrued income. Assume that the mortgage of $10,000.00 on S. B. North's property is owned by George Johnson. The interest is at 6 per cent payable semiannually, September 1 and March 1. On December 31, 4 months' interest, or $200 00, is accrued, therefore Johnson makes the following entry on December 31, assuming that this is the closing date of his accounting period.

*December 31*

| | | |
|---|---|---|
| *Interest Accrued* | *200 00* | |
| *Interest Income* | | *200 00* |
| *To show interest income on mortgage of $10,000 00 at 6 per cent for 4 months* | | |

On January 1, Johnson makes the following post-closing entry:

*January 1*

| | | |
|---|---|---|
| *Interest Income* | *200 00* | |
| *Interest Accrued* | | *200 00* |
| *To reverse the adjusting entry for interest income accrued on mortgage* | | |

The accounts for interest income and interest accrued on Johnson's books now stand as shown in Fig. 60.

**Interest Income**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Dec* | *31* | *Profit and Loss* | *J7* | *200 00* | *Dec* | *31* | *Interest Accrued* | *J6* | *200 00* |
| *Jan* | *1* | *Interest Accrued* | *J8* | *200 00* | | | | | |

**Interest Accrued**

| 19— | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | *31* | *Interest Income* | *J6* | *200 00* | *Jan.* | *1* | *Interest Income* | *J8* | *200 00* |

Fig 60

The student should compare the accounts shown in Fig. 60 with

those shown in Fig. 58 and note that they represent reverse conditions, one being the accounts of the debtor and the other being the accounts of the creditor.

**Deferred Expenses and Incomes.** In case of accrued expenses and incomes explained in preceding pages, payment thereof occurs at the end of the period of accrual; thus interest is paid at the end of each 6 months and taxes at the end of the year. It is now necessary to consider how expenses and incomes *paid in advance* should be treated in the accounts. Examples of expenses paid in advance are: (1) insurance, (2) rent, (3) advertising, (4) organization expense.

*1. Insurance.* Fire insurance is usually purchased on the basis of 1, 3, or 5 years. To illustrate the accounting procedure, assume that a fire insurance policy is taken out on property and the premium of $150.00 is prepaid for a 3-year period. Two alternative procedures will be illustrated. In the first place, the premium of $150.00 may be charged to an account entitled Prepaid Insurance which would then appear as shown in Fig. 61.

**Prepaid Insurance**

| | | | |
|---|---|---|---|
| 19— | | | |
| *July* | *1* | *Cash* | *150.00* |

Fig. 61

Assuming that the year is the accounting period and that it closes on December 31, insurance for 6 months will have expired. This amounts to $25.00. The adjusting entry on December 31 is as follows:

*December 31*

| | | |
|---|---|---|
| *Insurance Expense* | *25.00* | |
| *Prepaid Insurance* | | *25.00* |
| *For insurance expired since July 1.* | | |

After the preceding entry is posted, the Prepaid Insurance account appears as shown in Fig. 62.

**Prepaid Insurance**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *July* | *1* | *Cash* | | *150.00* | *Dec.* | *31* | *Insurance Expense* | *J7* | *25.00* |

Fig. 62

The procedure shown above is repeated until the entire amount in the Prepaid Insurance account is transferred to the Insurance Expense account. As in case of other expense accounts, the Insurance Expense account is carried to the Profit and Loss account at the end of the accounting period.

When the original debit for the insurance is made in the first place to an Insurance Expense account instead of to a Prepaid Insurance account, the procedure differs from the foregoing. Using the same illustration, assume that on July 1 the $150.00 is debited to an Insurance Expense account which then appears as shown in Fig. 63.

**Insurance Expense**

| 19— | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *July* | *1* | *Cash.........* | | *150* | *00* | | | | | |

Fig. 63

On December 31 the adjusting entry is as follows:

| | | |
|---|---|---|
| *Prepaid Insurance....................* | *125.00* | |
| *Insurance Expense..................* | | *125.00* |
| *To carry prepaid insurance to Prepaid Insurance account.* | | |

The Insurance Expense account and the Prepaid Insurance account now appear as shown in Fig. 64.

**Insurance Expense**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *July* | *1* | *Cash.........* | | *150* | *00* | *Dec.* | *31* | *Prepaid Insurance* | *J46* | *125* | *00* |

**Prepaid Insurance**

| 19- | | | | | |
|---|---|---|---|---|---|
| *Dec.* | *31* | *Insurance Expense* | *J46* | *125* | *00* |

Fig. 64

The balance in the Insurance Expense account, $25.00, is carried to Profit and Loss account. On January 1 the following post-closing entry is made.

*January 1*

| | | |
|---|---|---|
| *Insurance Expense.....................................* | *125.00* | |
| *Prepaid Insurance.....................................* | | *125.00* |
| *To reverse adjusting entry made December 31.* | | |

The accounts now appear as shown in Fig. 65.

**Insurance Expense**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *July* | *1* | *Cash..........* | | *150* | *00* | *Dec.* | *31* | *Prepaid Insurance* | *J46* | *125* | *00* |
| | | | | | | | *31* | *Profit and Loss..* | *J48* | *25* | *00* |
| | | | | *150* | *00* | | | | | *150* | *00* |
| *Jan.* | *1* | *Prepaid Insurance* | *J49* | *125* | *00* | | | | | | |

**Prepaid Insurance**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Dec.* | *31* | *Insurance Expense* | *J46* | *125* | *00* | *Jan.* | *1* | *Insurance Expense* | *J49* | *125* | *00* |

Fig. 65

2. *Rent.* The treatment of rent paid in advance is the same as that of insurance paid in advance. The debit may be made either to a Prepaid Rent account or to a Rent Expense account, and treated as already explained in connection with prepaid insurance. The student will profit by assuming a certain amount for prepaid rent, making the necessary adjusting entries, and setting up the necessary accounts. Both methods of procedure should be followed.

3. *Advertising.* Expenditures on advertising are usually regarded as applicable to the current period, in which event no adjustment is required at the close of the period. The amount shown on the debit side of the Advertising Expense account is simply carried to a Profit and Loss account by means of closing entries, as will be explained later. When, however, unusually large amounts are spent on an advertising campaign, it may be desirable to charge the entire amount to a Prepaid Advertising account and then write off this amount over two or more accounting periods.

To illustrate, assume that a concern in a given year spends $20,000.00 advertising a new article. It is decided that $10,000.00 of this amount should be regarded as expense for the current year

and the remaining $10,000.00 as expense for the following year. The entire amount of $20,000.00 should be charged to an Advertising Prepaid account as shown in Fig. 66.

**Advertising Prepaid**

| 19— | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.-July* | | *Cash* | | *20,000* | *00* | | | | | |

Fig. 66

On December 31 the following adjusting entry is made:

| | *December 31* | | |
|---|---|---|---|
| *Advertising Expense* | | *10,000.00* | |
| *Advertising Prepaid* | . . . | | *10,000.00* |
| *To carry one-half of Advertising Prepaid to Advertising Expense account.* | | | |

After this entry is posted, the Advertising Prepaid account appears as shown in Fig. 67.

**Advertising Prepaid**

| 19— | | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Jan.-July* | | *Cash* | . . . | *20,000* | *00* | *Dec.* | *31* | *Advertising Expense* | *J15* | *10,000* | *00* |

Fig. 67

*4. Organization Expense.* Organization expense results from the expenditure of considerable sums of money following the inception of a new enterprise. It may contain charges for legal expense, accountants' fees and services of various other experts required to put the business on its feet. It is a generally accepted procedure to write off the entire amount of organization expense over a period of from 3 to 5 years, preferably 3 years.

To illustrate, assume that the Jones Corporation during its first year of operations charges $8,000.00 to an Organization Expense account. This is written off to the Profit and Loss account over a period of three years, at the end of which time the account balances and appears as shown in Fig. 68.

**Organization Expense**

| 19— | | | | | 19— | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *Jan - Dec* | *Cash* | | 8,000 | 00 | *Dec.* | 31 | *Profit and Loss* | *J12* | 2,666 | 67 |
| | | | | | 19— *Dec.* | 31 | *Profit and Loss* | *J40* | 2,666 | 67 |
| | | | | | 19— *Dec.* | 31 | *Profit and Loss* | *J60* | 2,666 | 67 |
| | | | 8,000 | 00 | | | | | 8,000 | 00 |

Fig. 68

**Deferred Income.** When an income is received before it is earned, it must not be regarded as income on the date it is received. It must be carried as deferred income until it has been earned, when it may be treated as real income. As an illustration of deferred income, prepaid subscriptions received by a publisher on his magazine may be considered. Suppose that during a given year the Aaron Publishing Company receives subscriptions in advance for five years, amounting to a total of $100,000.00. If this entire amount is treated as income for the current year, the Aaron Publishing Company will be inflating its profits for the current year. It is reasonable to assume that only one-tenth of the amount, or $10,000.00 may be regarded as earned income and that during the next four years $20,000.00 will become earned income each year, leaving $10,000.00 to be treated as earned income during the sixth year. Assuming that these subscriptions were paid in the year 19–1, the Subscriptions Deferred Income account appears as shown in Fig. 69, when it is closed in 19–6.

**Deferred Subscriptions Income**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *19-1* | *Subscriptions Income* | *J10* | 10,000 | 00 | *19—* | *Cash . .* | | 100,000 | 00 |
| *19—* | *Subscriptions Income* | *J20* | 20,000 | 00 | | | | | |
| *19—* | *Subscriptions Income* | *J40* | 20,000 | 00 | | | | | |
| *19—* | *Subscriptions Income* | *J63* | 20,000 | 00 | | | | | |
| *19—* | *Subscriptions Income* | *J74* | 20,000 | 00 | | | | | |
| *19-6* | *Subscriptions Income* | *J88* | 10,000 | 00 | | | | | |
| | | | 100,000 | 00 | | | | 100,000 | 00 |

Fig. 69

In order to show the application of the principles explained in this chapter, there is given in Fig. 70 a trial balance of balances

taken from the ledger of James Morrison as at December 31, 19-7.

**James Morrison**

TRIAL BALANCE

**Year Ended December 31, 19-7**

| | | |
|---|---|---|
| *Cash in Bank* | 650.00 | |
| *Cash on Hand* | 50.00 | |
| *Inventory, Jan. 1, 19-7* | 67,000.00 | |
| *Accounts Receivable* | 41,600.00 | |
| *Notes Receivable* | 200.00 | |
| *Land* | 4,000.00 | |
| *Buildings* | 75,000.00 | |
| *Furniture and Fixtures* | 5,000.00 | |
| *Delivery Equipment* | 2,000.00 | |
| *Reserve for Depreciation on Buildings* | | 8,500.00 |
| *Reserve for Depreciation on Furniture and Fixtures* | | 1,000.00 |
| *Reserve for Depreciation on Delivery Equipment* | | 600.00 |
| *Investments* | 2,400.00 | |
| *Prepaid Insurance* | 600.00 | |
| *Accounts Payable* | | 13,000.00 |
| *Notes Payable* | | 800.00 |
| *Mortgage on Buildings* | | 10,000.00 |
| *James Morrison, Net Worth* | | 154,665.00 |
| *Purchases* | 400,000.00 | |
| *Sales* | | 450,000.00 |
| *Returned Sales* | 1,200.00 | |
| *Returned Purchases* | | 400.00 |
| *Salaries* | 12,000.00 | |
| *Wages* | 25,000.00 | |
| *Interest Expense* | 500.00 | |
| *Advertising* | 200.00 | |
| *Heat and Light* | 370.00 | |
| *Supplies* | 175.00 | |
| *Commissions* | 900.00 | |
| *Repairs* | 120.00 | |
| | 638,965.00 | 638,965.00 |

*Fig. 70*

This trial balance contains certain *mixed* accounts, as well as accounts which are strictly assets, liabilities, expenses, and revenues. The accounts which require attention in order to make the necessary adjusting entries are as follows: (1) Inventory, (2) Accounts Receivable, (3) Buildings, (4) Furniture and Fixtures, (5) Delivery Equipment, (6) Prepaid Insurance, (7) Mortgage on Buildings, (8) Purchases, (9) Wages, (10) Interest Expense, (11) Supplies.

1. The adjusting entry for inventory as at December 31, 19-7, is as follows:

| | | |
|---|---|---|
| *Purchases* | *67,000.00* | |
| *Inventory Jan. 1, 19–7* | | *67,000.00* |
| *To close to Purchases account.* | | |

2. It is estimated that 1 per cent of accounts receivable are uncollectible; therefore the entry on December 31, 19–7, to set up a reserve for bad debts is as follows:

| | | |
|---|---|---|
| *Bad Debts Expense* | *416.00* | |
| *Reserve for Bad Debts* | | *416.00* |
| *To set up Reserve for Bad Debts account of 1 per cent of accounts receivable as at December 31, 19–7.* | | |

3. It is estimated that the depreciation rate on buildings is 8 per cent yearly. Eight per cent of $75,000.00 is $6,000.00; therefore the adjusting entry is:

| | | |
|---|---|---|
| *Depreciation Expense* | *6,000.00* | |
| *Reserve Depreciation on Building* | | *6,000.00* |
| *To set up reserve for depreciation at the rate of 8 per cent per annum.* | | |

4. The depreciation rate on furniture and fixtures is 10 per cent per year; therefore the adjusting entry for depreciation is:

| | | |
|---|---|---|
| *Depreciation Expense* | *500.00* | |
| *Reserve Depreciation on Furniture and Fixtures* | | *500.00* |
| *To set up reserve on basis of 10 per cent depreciation rate.* | | |

5. It is estimated that the annual depreciation rate on delivery equipment is 25 per cent; therefore the adjusting entry is:

| | | |
|---|---|---|
| *Depreciation Expense* | *500.00* | |
| *Reserve Depreciation on Delivery Equipment* | | *500.00* |
| *For depreciation allowance at rate of 25 per cent per year.* | | |

6. Of the prepaid insurance, one-third or $200.00 represents insurance expense for the current year. The adjusting entry is:

| | | |
|---|---|---|
| *Insurance Expense* | *200.00* | |
| *Prepaid Insurance* | | *200.00* |
| *To adjust for expired insurance as at December 31, 19–7.* | | |

7. The mortgage bears interest at 7 per cent and this interest being payable September 1 and March 1, the interest accrued on the mortgage, as at December 31, is $233.33. The adjusting entry is:

| | | |
|---|---|---|
| *Interest Expense* | *233.33* | |
| *Interest Accrued* | | *233.33* |
| *For interest accrued on mortgage at 7 per cent as at Dec. 31, 19–7.* | | |

8. It is necessary to adjust the Purchases account for both opening inventory and closing inventory. The adjustment for the opening inventory is shown in (1) above. The inventory, as at December 31, 19—, is $73,000.00. The adjusting entry is:

| | | |
|---|---|---|
| *Inventory Dec. 31, 19–7* | *73,000.00* | |
| *Purchases* | | *73,000.00* |
| *To credit closing inventory to Purchases account and to debit the Inventory account.* | | |

9. On December 31 there is wages accrued but unpaid of $790.00. The adjusting entry is:

| | | |
|---|---|---|
| *Wages* | *790.00* | |
| *Wages Accrued* | | *790.00* |
| *For wages accrued as at Dec. 31.* | | |

10. This account has been adjusted in adjustment number 7, above.

11. Of the total of $175.00, there remains on hand $100.00; therefore the adjusting entry is:

| | | |
|---|---|---|
| *Supplies Expense* | *75.00* | |
| *Supplies* | | *75.00* |
| *To carry amount consumed to expense.* | | |

Morrison estimates that his taxes for the year will amount to $115.00. There is no account for taxes in the trial balance. The adjusting entry is:

| | | |
|---|---|---|
| *Taxes Expense* | *115.00* | |
| *Taxes Accrued* | | *115.00* |
| *For estimate of taxes for year 19–7.* | | |

There follows, in Fig. 71, the trial balance of James Morrison for the year ended December 31, 19–7, after the accounts have been adjusted by posting all of the adjusting entries shown above. This trial balance contains no mixed accounts. All mixed accounts have been adjusted. This trial balance is simply a trial balance of the ledger after the adjusting entries have been made in the journal and posted to the ledger. The use to which this trial balance can be put will be explained in the following chapter, which also takes up the subject of the post-closing trial balance.

## James Morrison

### Trial Balance

**Year Ended December 31, 19–7**

| | | |
|---|---|---|
| *Cash in Bank* | 650.00 | |
| *Cash on Hand* | 50.00 | |
| *Accounts Receivable* | 41,600.00 | |
| *Notes Receivable* | 200.00 | |
| *Land* | 4,000.00 | |
| *Buildings* | 75,000.00 | |
| *Furniture and Fixtures* | 5,000.00 | |
| *Delivery Equipment* | 2,000.00 | |
| *Reserve for Depreciation on Buildings* | | 6,000.00<br>8,500.00 |
| *Reserve for Depreciation on Furniture and Fixtures* | | 1,000.00<br>500.00 |
| *Reserve for Depreciation on Delivery Equipment* | | 600.00<br>500.00 |
| *Investments* | 2,400.00 | |
| *Prepaid Insurance* | 600.00 | 200.00 |
| *Accounts Payable* | | 13,000.00 |
| *Notes Payable* | | 800.00 |
| *Mortgage on Building* | | 10,000.00 |
| *James Morrison, Net Worth* | | 154,665.00 |
| *Purchases (Cost of Goods Sold)* | 67,000.00<br>400,000.00 | 73,000.00 |
| *Sales* | | 450,000.00 |
| *Returned Sales* | 1,200.00 | |
| *Returned Purchases* | | 400.00 |
| *Salaries* | 12,000.00 | |
| *Wages* | 790.00<br>25,000.00 | |
| *Interest Expense* | 233.33<br>500.00 | |
| *Advertising* | 200.00 | |
| *Heat and Light* | 370.00 | |
| *Supplies* | 175.00 | 75.00 |
| *Commissions* | 900.00 | |
| *Repairs* | 120.00 | |
| *Bad Debts Expense* | 416.00 | |
| *Reserve for Bad Debts* | | 416.00 |
| *Depreciation Expense—Buildings* | 6,000.00 | |
| *Depreciation Expense—Furniture and Fixtures* | 500.00 | |
| *Depreciation Expense—Delivery Equipment* | 500.00 | |
| *Depreciation Expense—Insurance* | 200.00 | |
| *Interest Accrued* | | 233.33 |
| *Inventory, Dec. 31, 19–7* | 73,000.00 | |
| *Wages Accrued* | | 790.00 |
| *Supplies Expense* | 75.00 | |
| *Taxes Expense* | 115.00 | |
| *Taxes Accrued* | | 115.00 |
| | 720,794.33 | 720,794.33 |

Fig. 71

## *Chapter 7*

# CLOSING ENTRIES; WORKING PAPERS

**Journal Entries Classified.** Journal entries may be classified into the following four divisions: (1) routine, (2) adjusting, (3) closing, (4) post-closing.

*1. Routine Journal Entries.* Routine journal entries are those made to reflect transactions. Many illustrations of these have already been given. They occur throughout the accounting period. The number of these entries may be small or large depending upon the character of the business and the character of the system of accounts in use. An example of a routine journal entry would be that in which goods are purchased on account from Thomas Smith and would be made as follows:

| | | |
|---|---|---|
| *Purchases* | *100 00* | |
| *Thomas Smith* | | *100 00* |
| *For purchase of goods on account.* | | |

*2. Adjusting Journal Entries.* Adjusting journal entries are those made usually, but not always, at the end of the accounting period for the purpose of separating the real and nominal elements in an account or for the purpose of bringing upon the books accrued expenses or incomes, etc.

In the foregoing paragraph the word *real* refers to the asset or liability element of the account. The word *nominal* refers to the expense or income element of a mixed account. After all the mixed accounts have been separated into their real and nominal elements, it may be said that all the accounts are then either real or nominal.

Many illustrations of adjusting entries are given in Chapter 6. It may be said that adjusting entries bring the books into agreement with the facts. Their importance cannot be overemphasized; and the student who has mastered the subject of adjusting entries has done much to achieve an understanding of accounting principles.

An example of an adjusting entry would be one required to bring the amount of the year's estimated taxes upon the books on December 31. The following illustration is given.

| | | | |
|---|---|---|---|
| | *December 31* | | |
| *Taxes Expense* | .. | *160.00* | |
| *Accrued Taxes* | .... | | *160 00* |
| *To bring upon books estimated taxes for 19—* | | | |

In the journal, adjusting entries should follow immediately after the routine entries. They should not be placed in a separate division of the journal. Sometimes an adjusting entry may be required at a date other than the closing date. In this case it should be brought in immediately following the preceding routine journal entry and may in turn be followed immediately by routine journal entries.

*3. Closing Entries.* Closing entries are made at the end of the accounting period after all necessary adjusting entries have been entered and posted. The purpose of closing entries is to carry to the Profit and Loss account all accounts showing income or expense; in other words, all nominal accounts. Closing entries should follow immediately after adjusting entries in the journal. These closing entries will be explained in this chapter.

*4. Post-closing Entries.* The post-closing entries are sometimes required to reverse adjusting entries. An illustration of a post-closing entry was given in connection with the discussion of accrued income, page 96.

**Closing Entries.** It is necessary to refer to the adjusted trial balance of James Morrison which is shown on page 105. The accounts in this trial balance, to and including James Morrison, Net Worth account, are all *real*. The accounts beginning with Purchases (Cost of Goods Sold) are all *nominal*, with the exception of the Reserve for Bad Debts account, Interest Accrued account, Inventory December 31, 19-7, account, Wages Accrued account, and Taxes Accrued account. At this point it is necessary to open in the ledger what is known as the Profit and Loss account. The Profit and Loss account is opened to serve as a clearing account for all expenses and all revenues. The purpose of the closing entries is to transfer the balances of all nominal items, that is, items of income

and expense, to the Profit and Loss account. Two methods of making the closing entry are as follows:

*1. First Method.* Under the first method each nominal account balance is closed out to the Profit and Loss account by making a separate debit or a separate credit to the Profit and Loss account. The closing entries under this method for James Morrison, as at December 31, 19–7, are as follows:

| | | |
|---|---|---|
| *December 31* | | |
| *Profit and Loss* | *394,000.00* | |
| *Purchases (Cost of Goods Sold)* | | *394,000.00* |
| *To close.* | | |
| *Sales* | *450,000.00* | |
| *Profit and Loss* | | *450,000.00* |
| *To close.* | | |
| *Profit and Loss* | *1,200.00* | |
| *Returned Sales* | | *1,200.00* |
| *To close.* | | |
| *Returned Purchases (Cost of Goods Sold)* | *400.00* | |
| *Profit and Loss* | | *400.00* |
| *To close.* | | |
| *Profit and Loss* | *12,000.00* | |
| *Salaries* | | *12,000.00* |
| *To close.* | | |
| *Profit and Loss* | *25,790.00* | |
| *Wages* | | *25,790.00* |
| *To close.* | | |
| *Profit and Loss* | *733.33* | |
| *Interest Expense* | | *733.33* |
| *To close.* | | |
| *Profit and Loss* | *200.00* | |
| *Advertising* | | *200.00* |
| *To close.* | | |
| *Profit and Loss* | *370.00* | |
| *Heat and Light* | | *370.00* |
| *To close.* | | |
| *Profit and Loss* | *900.00* | |
| *Commissions* | | *900.00* |
| *To close.* | | |
| *Profit and Loss* | *120.00* | |
| *Repairs* | | *120.00* |
| *To close.* | | |
| *Profit and Loss* | *416.00* | |
| *Bad Debts Expense* | | *416.00* |
| *To close.* | | |
| *Profit and Loss* | *6,000.00* | |
| *Depreciation Expense—Buildings* | | *6,000.00* |
| *To close.* | | |

| | | |
|---|---|---|
| *Profit and Loss* | 500.00 | |
| *Depreciation Expense—Furniture and Fixtures* | | 500.00 |
| *To close.* | | |
| *Profit and Loss* | 500.00 | |
| *Depreciation Expense—Delivery Equipment* | | 500.00 |
| *To close.* | | |
| *Profit and Loss* | 200.00 | |
| *Depreciation Expense—Insurance* | | 200.00 |
| *To close.* | | |
| *Profit and Loss* | 75.00 | |
| *Supplies Expense* | | 75.00 |
| *To close.* | | |
| *Profit and Loss* | 115.00 | |
| *Taxes Expense* | | 115.00 |
| *To close.* | | |

When these journal entries are posted, all nominal accounts, that is, all income and expense accounts, will be closed and the Profit and Loss account will appear as shown in Fig. 72.

**Profit and Loss**

| 19-7 | | | | | 19-7 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Dec. | 31 | Purchases | J10 | 394,000.00 | Dec. | 31 | Sales | J10 | 450,000.00 |
| | | Returned Sales | J10 | 1,200.00 | | | Returned Purchases | J10 | 400.00 |
| | | Salaries | J10 | 12,000.00 | | | | | |
| | | Wages | J10 | 25,790.00 | | | | | |
| | | Interest Expense | J10 | 733.33 | | | | | |
| | | Advertising | J10 | 200.00 | | | | | |
| | | Heat and Light | J10 | 370.00 | | | | | |
| | | Commissions | J10 | 900.00 | | | | | |
| | | Repairs | J10 | 120.00 | | | | | |
| | | Bad Debt Expense | J10 | 416.00 | | | | | |
| | | Depreciation Expense—Buildings | J10 | 6,000.00 | | | | | |
| | | Depreciation Expense—Furniture and Fixtures | J10 | 500.00 | | | | | |
| | | Depreciation Expense—Delivery Equipment | J10 | 500.00 | | | | | |
| | | Depreciation Expense—Insurance | J10 | 200.00 | | | | | |
| | | Supplies Expense | J10 | 75.00 | | | | | |
| | | Tax Expense | J10 | 115.00 | | | | | |
| | | J. Morrison, Net Worth | J10 | 7,280.67 | | | | | |
| | | | | 450,400.00 | | | | | 450,400.00 |

Fig. 72

The net profit for the year is shown to be \$7,280.67. This is the excess of the credit items in the Profit and Loss account over the debit items, the last debit item being \$115.00. A final closing entry is required to carry this profit of \$7,280.67 to J. Morrison, Net Worth account. This entry is as follows:

| | | |
|---|---|---|
| *Profit and Loss* | 7,280.67 | |
| *J. Morrison, Net Worth* | | 7,280.67 |
| *To close.* | | |

After the foregoing entry is posted, the Profit and Loss account should be ruled up as shown in Fig. 72.

2. *Second Method.* Under the second method the entries in which the Profit and Loss account is debited are combined into a single compound entry; likewise, the entries in which the Profit and Loss account is credited are combined into a single entry. Under this method the closing entries for James Morrison, as at December 31, 19–7, are as follows:

*December 31*

| | | |
|---|---|---|
| *Profit and Loss* | 443,119.33 | |
| *Purchases (C.G.S.)* | | 394,000.00 |
| *Returned Sales* | | 1,200.00 |
| *Salaries* | | 12,000.00 |
| *Wages* | | 25,790.00 |
| *Interest Expense* | | 733.33 |
| *Advertising* | | 200.00 |
| *Heat and Light* | | 370.00 |
| *Commissions* | | 900.00 |
| *Repairs* | | 120.00 |
| *Bad Debt Expense* | | 416.00 |
| *Depreciation Expense—Buildings* | | 6,000.00 |
| *Depreciation Expense—Furniture and Fixtures* | | 500.00 |
| *Depreciation Expense—Delivery Equipment* | | 500.00 |
| *Depreciation Expense—Insurance* | | 200.00 |
| *Supplies Expense* | | 75.00 |
| *Tax Expense* | | 115.00 |
| *To close.* | | |
| *Sales* | 450,000.00 | |
| *Returned Purchases* | 400.00 | |
| *Profit and Loss* | | 450,400.00 |
| *To close.* | | |
| *Profit and Loss* | 7,280.67 | |
| *J. Morrison, Net Worth* | | 7,280.67 |

After the closing entries are made by either method and posted, another trial balance known as the post-closing trial balance should

be taken for James Morrison; this post-closing trial balance, as at December 31, 19–7, is as shown in Fig. 73.

**James Morrison**
POST-CLOSING TRIAL BALANCE
**as at December 31, 19–7**

| | | |
|---|---|---|
| *Cash in Bank* | 650.00 | |
| *Cash on Hand* | 50.00 | |
| *Accounts Receivable* | 41,600.00 | |
| *Notes Receivable* | 200.00 | |
| *Land* | 4,000.00 | |
| *Buildings* | 75,000.00 | |
| *Furniture and Fixtures* | 5,000.00 | |
| *Delivery Equipment* | 2,000.00 | |
| *Reserve for Depreciation on Buildings* | | 14,500.00 |
| *Reserve for Depreciation on Furniture and Fixtures* | | 1,500.00 |
| *Reserve for Depreciation on Delivery Equipment* | | 1,100.00 |
| *Investments* | 2,400.00 | |
| *Prepaid Insurance* | 600.00 | 200.00 |
| *Accounts Payable* | | 13,000.00 |
| *Notes Payable* | | 800.00 |
| *Mortgage on Building* | | 10,000.00 |
| *James Morrison, Net Worth* | | 161,945.67 |
| *Supplies* | 100.00 | |
| *Reserve for Bad Debts* | | 416.00 |
| *Interest Accrued* | | 233.33 |
| *Inventory, Dec. 31, 19–7* | 73,000.00 | |
| *Wages Accrued* | | 790.00 |
| *Taxes Accrued* | | 115.00 |
| | 204,600.00 | 204,600.00 |

The post-closing trial balance contains only real accounts, that is, asset accounts, liability accounts, and net worth accounts. The revenue and expense accounts were all closed out to Profit and Loss account and the balance of the Profit and Loss account was carried to J. Morrison, Net Worth account by means of the last closing entry. The post-closing trial balance is simply a list of the ledger accounts of James Morrison which still have balances. The purpose of the post-closing trial balance is twofold, as follows: (1) to prove the accuracy of the ledger; (2) to provide data for the preparation of the balance sheet. See Fig. 75.

The data for the preparation of the profit and loss statement is secured chiefly from the Profit and Loss account, but it is necessary

**James Morrison**

WORKING PAPER

**Year Ended December 31, 19–7**

| Account Title | Trial Balance Dr. | Trial Balance Cr. | Adjustments Dr. | Adjustments Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. | Profit and Loss Dr. | Profit and Loss Cr. | Balance Sheet Dr. | Balance Sheet Cr. |
|---|---|---|---|---|---|---|---|---|---|---|
| *Cash in Bank* | 650.00 | | | | 650.00 | | | | 650.00 | |
| *Cash on Hand* | 50.00 | | | | 50.00 | | | | 50.00 | |
| *Inventory, Jan. 1, 19–7* | 67,000.00 | | | (1)67,000.00 | | | | | | |
| *Accounts Receivable* | 41,600.00 | | | | 41,600.00 | | | | 41,600.00 | |
| *Notes Receivable* | 200.00 | | | | 200.00 | | | | 200.00 | |
| *Land* | 4,000.00 | | | | 4,000.00 | | | | 4,000.00 | |
| *Buildings* | 75,000.00 | | | | 75,000.00 | | | | 75,000.00 | |
| *Furniture and Fixtures* | 5,000.00 | | | | 5,000.00 | | | | 5,000.00 | |
| *Delivery Equipment* | 2,000.00 | | | | 2,000.00 | | | | 2,000.00 | |
| *Reserve for Depreciation—Buildings* | | 8,500.00 | | (3) 6,000.00 | | 14,500.00 | | | | 14,500.00 |
| *Reserve for Depreciation—Furniture and Fixtures* | | 1,000.00 | | (4) 500.00 | | 1,500.00 | | | | 1,500.00 |
| *Reserve for Depreciation—Delivery Equipment* | | 600.00 | | (5) 500.00 | | 1,100.00 | | | | 1,100.00 |
| *Investments* | 2,400.00 | | | | 2,400.00 | | | | 2,400.00 | |
| *Prepaid Insurance* | 600.00 | | | (6) 200.00 | 400.00 | | | | 400.00 | |
| *Accounts Payable* | | 13,000.00 | | | | 13,000.00 | | | | 13,000.00 |
| *Notes Payable* | | 800.00 | | | | 800.00 | | | | 800.00 |
| *Mortgage on Buildings* | | 10,000.00 | | | | 10,000.00 | | | | 10,000.00 |
| *James Morrison, Net Worth* | | 154,665.00 | | | | 154,665.00 | | | | 154,665.00 |
| *Purchases* | 400,000.00 | | (1)67,000.00 | (8)73,000.00 | 394,000.00 | | 394,000.00 | | | |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Sales | | 450,000 00 | | | | 450,000 00 | | 450,000 00 | | |
| Returned Sales | 1,200 00 | | | | 1,200 00 | | 1,200 00 | | | |
| Returned Purchases | | 400 00 | | | | 400 00 | | 400 00 | | |
| Salaries | 12,000 00 | | | | 12,000 00 | | 12,000 00 | | | |
| Wages | 25,000 00 | | (9) 790 00 | | 25,790 00 | | 25,790 00 | | | |
| Interest Expense | 500 00 | | (7) 233 33 | | 733 33 | | 733 33 | | | |
| Advertising | 200 00 | | | | 200 00 | | 200 00 | | | |
| Heat and Light | 370 00 | | | | 370 00 | | 370 00 | | | |
| Supplies | 175 00 | | | (11) 75 00 | 100 00 | | | | 100 00 | |
| Commissions | 900 00 | | | | 900 00 | | 900 00 | | | |
| Repairs | 120 00 | | | | 120 00 | | 120 00 | | | |
| Bad Debts Expense | | | (2) 416 00 | | 416 00 | | 416 00 | | | |
| Reserve for Bad Debts | | | | (2) 416 00 | | 416 00 | | | | 416 00 |
| Depreciation Expense—Buildings | | | (3) 6,000 00 | | 6,000 00 | | 6,000 00 | | | |
| Depreciation Expense—Furniture and Fixtures | | | (4) 500 00 | | 500 00 | | 500 00 | | | |
| Depreciation Expense—Delivery Equipment | | | (5) 500 00 | | 500 00 | | 500 00 | | | |
| Insurance Expense | | | (6) 200 00 | | 200 00 | | 200 00 | | | |
| Interest Accrued | | | | (7) 233 33 | | 233 33 | | | | 233 33 |
| Inventory, Dec. 31, 19–7 | | | (8) 73,000 00 | | 73,000 00 | | | | 73,000 00 | |
| Wages Accrued | | | | (9) 790 00 | | 790 00 | | | | 790 00 |
| Supplies Expense | | | (11) 75 00 | | 75 00 | | 75 00 | | | |
| Taxes Accrued | | | | (12) 115 00 | | 115 00 | | | | 115 00 |
| Taxes Expense | | | (12) 115 00 | | 115 00 | | 115 00 | | | |
| Net Profit for Year | | | | | | | 7,280 67 | | | 7,280 67 |
| | 638,965 00 | 638,965 00 | 148,829 33 | 148,829 33 | 647,519 33 | 647,519 33 | 450,400 00 | 450,400 00 | 204,400 00 | 204,400 00 |

Fig. 74

to refer to the primary trial balance of Morrison to ascertain the amounts of the opening and closing inventories, respectively. The statement of profit and loss for Morrison for the year ended December 31, 19–7, is shown in Fig. 76.

**The Working Paper.** The purpose of the working paper is to show the preliminary trial balance, adjustments thereof, the adjusted trial balance (sometimes omitted) the Profit and Loss account and the post-closing trial balance (sometimes called balance sheet). Given the preliminary trial balance, it is possible to reflect on the working paper all facts relative to adjusting and closing entries before making these entries in the books of account. The advantage of this procedure is obvious. It makes it possible to check the accuracy of the entire process of adjusting and closing before entering the adjusting and closing entries on the books. Fig. 74 shows the working paper for James Morrison for the year ended December 31, 19–7. In the first two columns are shown the adjustments, which are identical with the adjusting entries already explained in Chapter 6. In the next two columns is shown the adjusted trial balance. In practice, the adjusted trial balance frequently is omitted, but at this point it seems desirable to show it on the working paper. It contains no mixed accounts. After the necessary adjustments are made in a trial balance, all accounts are then either real or nominal.

The next step is to transfer all nominal items in the adjusted trial balance to the profit and loss columns and all real items to the balance sheet columns of the working paper. The items found in the profit and loss columns of the working paper may be compared profitably with the items shown in the Profit and Loss account, Fig. 72. Note that the balance representing the net profit of $7,280.67 is placed at the foot of the debit profit and loss column. This is equivalent to the last closing entry, shown on page 110. In the balance sheet the net profit of $7,280.67 should be regarded as an addition to James Morrison, Net Worth account, although for convenience it is shown as the last item in the credit balance sheet column. Many accountants in practice prefer to carry out the entire adjusting and closing process on the working paper before making any adjusting and closing entries in the journal. In so doing they reverse

the procedure followed in this and preceding chapters, in which the explanation of the working paper has been made to follow the explanation of the adjusting and closing process. This has been done here for purposes of clearness, but after the student has familiarized himself with the working paper procedure, he will find it a most useful method of preparing to close the books.

# *Chapter* 8

# CONSTRUCTION AND INTERPRETATION OF STATEMENTS

**Purpose of Accounting Statements.** The work of keeping records of transactions is of little use unless at regular intervals the results can be summarized and interpreted for the benefit of all interested parties. Fortunately, much attention has been given to the problem of summarization and analysis in recent years, so that there now exists a scientific procedure relative to the classification of assets, liabilities, and net worth and, which is of equal importance, the classification of revenues and expenses. The scientific collection of income and expense data in accordance with detailed classifications of accounts is the distinguishing characteristic of the double entry system. Under single entry systems of bookkeeping, the information recorded is incomplete, particularly with reference to expense classifications. Under single entry methods, fairly adequate balance sheets are constructed, but no satisfactory information is found relative to why and how net worth increased or decreased during a given accounting period. Under double entry methods, information relative to expenses may be secured in as great detail as the size and character of the business warrant. It is particularly gratifying, therefore, to realize that under the methods explained in this book it is possible to secure not only adequate balance sheets setting forth the financial condition of an enterprise at the end of each accounting period, but it also is possible to secure adequate profit and loss statements explaining in detail the increase or decrease occurring in net worth during the accounting period, and known as either the profit or the loss for the accounting period.

The purposes for which accounting statements, that is, the balance sheet and profit and loss statement, may be used are many, but for this study they will be limited to three, viz.: (1) to aid management, (2) to aid investors, (3) to secure credit at banks.

*1. Management.* Management is the science of control in a given enterprise. Formerly, managers operated largely by rule-of-thumb methods, supplemented by what is known as intuition. It will be granted that such intangible factors as judgment, character, and personality will be needed always in management; nevertheless, this truth being granted, management must, in addition, be based on accurate information relative to all important aspects of a business. As competition grows keener and the margins of profit diminish, managers, of necessity, are required to base their policies on analyses of accounting data. The accountant must continue to be a right-hand man to the manager. Good intentions are likely to end in disaster, unless there is always sufficient data of facts to enable management to correct undesirable trends.

The manager must have up-to-date information. This can be supplied to him only when the accounts are so complete as to enable the accounting department to supply to the manager promptly the required information.

One of the important functions of management is to *spot* unprofitable activities. This usually can be done only by the proper departmentalization of an enterprise. This is at least a partial explanation of the department store. Each department is accounted for as if it were a separate undertaking. In this way it is possible to eliminate those portions of an enterprise which cannot be made to operate at a profit.

The word *cost* is of great significance in management. To the purchaser of an article, cost may be simply the price paid; but in all lines of manufacture, as well as in other fields of commercial activity, the determination of cost, as applied to output produced and services rendered, may be a highly complicated problem. Manufacturers must, however, know cost to sell intelligently and to formulate policies relative to the introduction of new articles of output and the elimination of others.

The relationship of accounting to management may well occupy the attention of the student of modern business methods. The manufacturer who is not supplied promptly with statements and analyses of statements lacks the information necessary for the intelligent control of his business.

*2. Investment.* To a great extent, capital used in modern business is provided by people who take no direct interest in management. The modern corporation sells stocks and bonds to thousands of investors, who intrust their wealth to the men who control the policies of the corporation. It is a kind of absentee ownership. It is not unnatural, therefore, that investors, many of whom never see the plant and equipment of the enterprise in which they invest, should demand that they be presented at frequent intervals with informative statements setting forth the progress and condition of the enterprise in which they have invested their money. The investor may not be a financial expert, but he usually has a sufficient understanding of financial statements to enable him to read them with profit. If he cannot do this, he depends upon a business analyst to clarify statements for him. In any event, modern investors are fully justified in refusing to purchase the securities of corporations which refuse to supply promptly the necessary statements.

There are today many investment services which perform the work of analysis and interpretation for their customers. These services can analyze and explain only such statements as are submitted to them. As a rule, it is advantageous for a corporation to submit to analysts, investors, and stock exchanges full information relative to its operations and financial condition. The requirements of such agencies as the Securities and Exchange Commission and the New York Stock Exchange render it necessary for modern corporations to prepare statements which meet the demands of these agencies.

It may be expected that government, particularly the federal government, will continue to interest itself in ways of affording protection to investors. Moreover, state blue-sky laws will continue to exercise control over the intrastate sale of securities. These considerations show clearly the importance of following correct accounting procedure in order to meet the demands of governmental as well as private agencies.

*3. Bank Credit.* Not only do corporations secure capital by selling stocks and bonds, but they frequently seek help at banks. The credit granted by banks to corporations is usually short-term credit, intended to carry the business over seasonal periods. Individuals and

partnerships, as well as corporations, seek this kind of credit at banks. An illustration of the credit granted by the usual type of commercial bank would be the loaning of money in November to a department store to enable it to make purchases for the holiday season. It would be expected that the loan would be repaid at about the close of the holiday season when the merchandise purchased by the aid of the bank's loan would be liquidated and cash made available. At this point, it may be noted that there is a tendency at the present time toward the extension of the term of bank credit making it possible for banks to give long-term aid.

In any event, banks are particular to request from those seeking credit statements indicative of financial condition and ability to repay loans. Because of the character of bank credit, bankers give particular attention to what may be termed the working capital position of the enterprise. *Working capital* is simply the excess of current assets over current liabilities, and the *working capital ratio* is the ratio of current assets to current liabilities. Assuming that a concern's current assets are $300,000.00 in amount and current liabilities $100,000.00 in amount, the working capital is $200,000.00 and the working capital ratio is 3–1. These are the considerations which bankers keep in mind when considering the extension of credit. They are less interested in fixed assets and usually discount intangible assets, such as goodwill, 100 per cent.

The importance of maintaining at banks a satisfactory standing cannot be overemphasized. Correct accounts, together with the statements which it is possible to derive therefrom, go a long way toward the maintenance of good standing at banks.

**Sources of Data for Statements.** The statements issued by enterprises are derived from various sources and accompanied by explanations of various kinds. Typical of these statements are those found in annual reports of corporations and, sometimes, in quarterly reports. In case of small enterprises having inadequate accounting records, memoranda may serve as an important source of information. In case of large enterprises having adequate systems of accounts, memoranda may nevertheless perform an important function; since under this title may be included all classes of information in written form, not a part of the double entry system of accounts.

Memoranda should be preserved as long as they serve a useful purpose. Adequate filing systems make it possible to locate all material of a miscellaneous character.

Where properly kept systems of accounts are found, it frequently is necessary to determine the authority for entries made on the accounting records, as, for example, the authority for a dividend or the authority for the purchase of a building, or the authority for the payment of certain salaries. Where journal entries are made, reference should occur in the explanation to the journal entries, indicating where the necessary supplementary documents may be found.

Where single entry records are kept, the information available for the preparation of statements is not usually complete, especially information required for the preparation of a profit and loss statement. This is because, in single entry, accounts for expenses and revenues may not be kept. The information required for the preparation of a balance sheet is usually more complete, but even it may be inadequate. Under these conditions it is necessary to use whatever additional data it is possible to secure from other sources than the accounting records.

**Working Paper as Source of Data.** Where accounts are kept by the double entry method and a satisfactory classification of accounts exists, the working paper affords all of the data necessary for the preparation of both the balance sheet and the profit and loss statement. In Fig. 75 is shown the balance sheet of James Morrison, as at December 31, 19–7, and in Fig. 76 is the statement of profit and loss for James Morrison for the year ended December 31, 19–7.

The balance sheet (Fig. 75) and the profit and loss statement (Fig. 76) of James Morrison are constructed from data which is found in the working paper (Fig. 74). The balance sheet data is found in the balance sheet columns of the working paper. All of the data required for the profit and loss statement is found in the profit and loss columns of the working paper, except that in order to show how cost of goods sold is determined, it is necessary to refer to the opening and closing inventories which appear in the preliminary trial balance and the adjusted trial balance, respectively.

The student will profit by setting up these statements and bring-

**James Morrison**
BALANCE SHEET
**as at December 31, 19–7**

| | | | |
|---|---|---|---|
| Current Assets: | | | |
| Cash in Bank | | $ 650.00 | |
| Cash on Hand | | 50.00 | |
| Inventory, Dec. 31, 19— | | 73,000.00 | |
| Accounts Receivable | $41,600.00 | | |
| Less Reserve for Bad Debts | 416.00 | 41,184.00 | |
| Notes Receivable | | 200.00 | |
| Supplies | | 100.00 | $115,184.00 |
| Fixed Assets: | | | |
| Land | | $ 4,000.00 | |
| Building | $75,000.00 | | |
| Less Reserve for Depreciation | 14,500.00 | 60,500.00 | |
| Furniture and Fixtures | $ 5,000.00 | | |
| Less Reserve for Depreciation | 1,500.00 | 3,500.00 | |
| Delivery Equipment | $ 2,000.00 | | |
| Less Reserve for Depreciation | 1,000.00 | 900.00 | 68,900.00 |
| Investments | | | 2,400.00 |
| Deferred Assets: | | | |
| Prepaid Insurance | | | 400.00 |
| | | | $186,884.00 |

| | | |
|---|---|---|
| Current Liabilities: | | |
| Accounts Payable | $13,000.00 | |
| Notes Payable | 800.00 | |
| Taxes Accrued | 115.00 | |
| Interest Accrued | 233.33 | |
| Wages Accrued | 790.00 | $ 14,938.33 |
| Fixed Liability: | | |
| Mortgage | | 10,000.00 |
| Net Worth: | | |
| James Morrison, Capital | | 161,945.67 |
| | | $186,884.00 |

Fig. 75

**James Morrison**

PROFIT AND LOSS STATEMENT

**Year Ended December 31, 19–7**

| | | | |
|---|---|---|---|
| *Sales* | | | 450,000.00 |
| *Less Returns* | | | 1,200.00 |
| *Net Sales* | | | 448,800.00 |
| *Less Cost of Goods Sold:* | | | |
| *Inventory, January 1, 19—* | | 67,000.00 | |
| *Purchases (Net)* | | 399,600.00 | |
| | | 466,600.00 | |
| *Inventory, December 31, 19—* | | 73,000.00 | 393,600.00 |
| *Gross Profit* | | | 55,200.00 |
| *Deduct Operating Expenses:* | | | |
| *Selling:* | | | |
| *Depreciation—Delivery Equipment* | 500.00 | | |
| *Advertising* | 200.00 | | |
| *Wages* | 25,790.00 | | |
| *Commissions* | 900.00 | 27,390.00 | |
| *Administrative:* | | | |
| *Salaries* | 12,000.00 | | |
| *Heat and Light* | 370.00 | | |
| *Repairs* | 120.00 | | |
| *Bad Debts* | 416.00 | | |
| *Depreciation* | 6,500.00 | | |
| *Insurance* | 200.00 | | |
| *Taxes* | 115.00 | | |
| *Supplies* | 75.00 | 19,796.00 | |
| *Financial:* | | | |
| *Interest* | | 733.33 | 47,919.33 |
| *Net Profit for Year* | | | 7,280.67 |

Fig. 76

ing in the names of accounts and the amounts, securing them from the working paper. He will thus obtain a better knowledge of the uses to which working paper data can be put.

**Comments on Balance Sheet.** The balance sheet of James Morrison (Fig. 75) is in account form and follows the customary procedure of showing current assets and current liabilities first. The purpose of the classification of assets into current, fixed, investments, and deferred is to enable the reader of the balance sheet to secure an understanding of the way in which the total funds of the business are being used. The purpose of the classification on the liability side of the balance sheet into current, fixed, and net worth

is to indicate the manner in which the business is owned, or, in other words, to show what are known as the equities, or interests in the business.

In attempting to interpret a balance sheet, the reader is naturally guided by the purpose which he has in view. A banker contemplating the granting of short-term credit to Morrison will be interested primarily in the working capital position. In other words, his chief interest is in the current assets and current liabilities. Morrison's balance sheet shows an unusually good working capital position, the current assets being more than seven times the current liabilities. The working capital ratio is approximately 7–1, and the working capital is $100,245.67. It may be asked how it is possible for Morrison to achieve this splendid working capital position. This is possible because Morrison himself provides most of the funds for the business, his capital being nearly $162,000.00. In case of less favorably placed enterprises, it would be impossible to carry as much in the form of inventories, and it would be necessary to show a greater amount of current liabilities. Morrison's cash position appears to be weak, since he has a total of only $700.00 in cash. It would appear, however, that he should be able to borrow from banks in the event of a shortage in cash.

One of the most important problems in management is to produce in the balance sheet what may be termed satisfactory ratios. If, for example, an excessive amount is invested in inventories of merchandise, there results the needless tying up of funds. The same may be said of accounts receivable which require the continuous observation of the credit department if they are to be kept in strictly liquid condition.

As has been said, the test of current assets is that they be in the form of cash or that they be items which in the natural course of business will be converted into cash. The student may apply this test to the current asset items in Morrison's balance sheet. The only item about which a question may be raised is supplies. Although it is true that supplies will not be sold directly for cash or on account, nevertheless, they will be charged to customers, probably entirely within the next year, and will be converted into cash as collections are made on sales.

The student also may apply the test of Current Liabilities, namely, that they are to be paid within one year. It seems reasonable to assume that this is true of all items shown in the current liabilities division of the balance sheet.

The test of Fixed Assets is that they are to be used in the business and are not to be sold. This is obviously true of all items shown as fixed assets. If the land were not being entirely used in the business, it should have been subdivided into land used and land not used and the value of the unused land shown under investments. It is reasonable to assume, therefore, that all the land is being used in operations.

The test of Investments is that they represent capital not being used in operations. Investments may take such forms as stocks, bonds, or land not currently used in operations. If the investment item is important, a classification thereof should appear in the balance sheet. Since $2,400.00 represents but a small fraction of the entire capital used, showing it as a single item is not subject to criticism.

The test of Deferred Assets is that they represent expenses applicable to the future. This is obviously true of prepaid insurance.

The only fixed liability is the mortgage of $10,000.00 which does not mature within the coming year. Were its maturity date close at hand, say, eight or ten months hence, it would probably be transferred to the current liabilities division. This would not be true, however, in case arrangements for its renewal had been made.

The net worth section of the balance sheet indicates the amount of Morrison's equity, or real ownership in the business. Legally speaking, Morrison is the owner of the business, but equitably speaking, his interest is considerably less than 100 per cent, because of the equities represented by the current liabilities and by the mortgage. Although the net worth is shown on what is known as the liability side of the balance sheet, it is not, strictly speaking, a liability. Of course the business may be looked upon as responsible to Morrison for the amount of the net worth, but this is an obligation which has no maturity date, as do mortgages and current liabilities. The student now should be in a position to appreciate the statement that a balance sheet is an equation in which the assets equal the

liabilities plus the net worth. This may be stated mathematically as follows.

$$\text{Assets} = \text{Liabilities} + \text{Net Worth}$$

**Comments on Profit and Loss Statement.** The profit and loss statement for James Morrison is shown in Fig. 76. It is in statement form and follows recognized standards in the construction of such statements. The sales of $450,000.00 is the gross revenue figure from which is deducted the returned sales of $1,200.00, leaving a net sales figure of $448,800.00. This is the gross revenue or income of the business. Against this figure for gross revenue must be offset all expenses for the business, including the cost of goods sold. In this instance, the cost of goods sold is found to be $393,600.00. The method of determining cost of goods sold has been explained, but it may be reviewed at this point. To the opening inventory of $67,000.00 is added purchases (net) of $339,600.00, making a total of $446,600.00 to account for. Of this amount, $73,000.00 remains on hand in the closing inventory, December 31. This leaves, as the cost of goods sold, $393,600.00. This is one of the expenses of doing business and when deducted from the net sales figure of $448,800.00 it leaves a gross profit of $55,200.00.

Gross profit is an item requiring some consideration. It does not represent increase in net worth. It is simply the excess of net sales over cost of goods sold. It is what is left, therefore, to defray remaining expenses. Obviously, no business can limit its expenses to cost of goods sold. Salaries must be paid, depreciation must be allowed, and many other items of expense must be covered.

Operating expenses are classified in various ways in profit and loss statements. The classification into selling, administrative, and financial, shown in Morrison's profit and loss statement, may be regarded as fairly typical of good procedure. The subdivisions under selling expense, administrative expense, and financial expense are not, however, intended to be more than simply illustrative. The detailed items of selling, administrative, and financial expense must reflect the character of the business in question. If salaries are paid to promote sales, they should be shown in the selling expense division of the profit and loss statement. If some depreciation other than depreciation on delivery equipment is incurred in connection with

selling, it should be shown as a selling expense. The student must look upon the classification of expenses in Morrison's profit and loss statement as merely tentative and to be modified or expanded as conditions require.

Under selling expenses should be included all items of expense necessitated in connection with the promotion and carrying out of sales. Advertising and salesmen's commissions are typical of such expenses. The wages item of $25,790.00 is presumably the amount paid clerks in the store.

Administrative expenses are those incurred in connection with management. It is obvious that some administrative expense must be incurred in connection with sales, but it should be shown in the administrative expense section of the statement. Examples of administrative expenses are salaries of administrative officers, such as the president and vice-president. Bad debts are sometimes regarded as a financial expense.

Financial expenses are those incurred in connection with the securing of funds. Interest is typical of such expense. Where cash discounts on sales are granted, they are sometimes regarded as financial expense and sometimes as selling expense; circumstances must determine. Where discounts on purchases are received, they are sometimes treated as financial income and sometimes regarded as a deduction from purchases; here again circumstances govern.

The manner in which the details of the profit and loss statement are marshaled in order to give clearness, and yet show a sufficient amount of detail, should be noted. In Morrison's profit and loss statement three columns are required for this purpose. Details are expressed in the first column. In the second column, the computation of cost of goods sold is made and the totals of selling, administrative, and financial expense are listed. In the third column, the final result is achieved by deducting from the sales figure, not only sales returns, but cost of goods sold and the total of operating expenses. The final result is the net profit for the year, namely, $7,280.67. This represents Morrison's increase in net worth as a result of his business enterprise.

It may be assumed that the salaries item of $12,000.00 represents salaries paid to employees. If Morrison pays himself a salary, this

must be included in the net profit figure. For example, if Morrison drew a salary of $5,000.00, his net profit for the year is not $7,280.67, but $12,280.67. In other words, any salary which a sole proprietor pays to himself is a distribution of profit.

**Balance Sheets in General.** At this point it is possible to generalize somewhat in the consideration of the balance sheet. Obviously, balance sheets, like other statements, must be devised to fulfill certain purposes. The expression *General Balance Sheet* and the expression *Special Balance Sheet* may be explained.

A general purpose balance sheet is one intended to fulfill as many requirements as a single balance sheet can be made to do. Most balance sheets found in the published reports of corporations are of this kind. They are intended to be read by stockholders, investors, analysts, and any others interested in the financial standing of the concern in question. It appears, however, that with the refinements which may be introduced in accounting procedure and in the work of analysis and interpretation of statements, it may become necessary to devise more balance sheets of the special purpose type.

Perhaps the best illustration which exists today of the special purpose balance sheet is that which some bankers require to be provided on their own forms and which, therefore, are intended for the specific purpose of enabling the banker to pass judgment on the ability of a concern to meet short-term obligations. The balance sheets required of corporations when submitting income tax returns to the federal government may be regarded as special purpose balance sheets. This is true also of balance sheets prepared to fulfill the requirements of the New York Stock Exchange and the Securities and Exchange Commission.

Sometimes a special purpose balance sheet is simply a modification, or a rearrangement, of a general purpose balance sheet, the alterations being made to meet the requirements of the agency to whom the balance sheet is to be submitted. Obviously, the essential facts set forth in a special purpose balance sheet must be the same as those set forth in a general purpose balance sheet, for the same enterprise. The change in form or arrangement is made in order to emphasize or render specially clear certain facts. In case of a special

purpose balance sheet, prepared for short-term credit purposes, emphasis is placed on the working capital position; hence, special attention is given to current assets and current liabilities, and they are naturally given a place of prominence on the balance sheet. It is possible that the current assets and the current liabilities will be shown in greater detail than they would be shown on a general purpose balance sheet. It is possible also that supplementary information in the form of a questionnaire may be made to shed additional light on the working capital position.

**Balance Sheet Variations.** Irrespective of whether balance sheets are of a general purpose or of a special purpose, it will be found that in practice wide variations of arrangement and construction occur. Some of these variations are unnecessary and undesirable, but others simply reflect the differences which exist in the different types of business and commercial enterprises. The student of accounting must avoid the temptation of trying to reduce all balance sheets to a common form and arrangement. He must expect to find surprising variations from the balance sheet shown in Fig. 75 when he begins the study of balance sheets published in the reports of corporations.

In the first place, the net worth of corporations must be expressed in the form of capital stock and surplus, whereas the net worth of sole proprietorships and partnerships is expressed in the form of proprietorship accounts.

In the second place, the nature of business enterprises varies so greatly that it is only natural that balance sheets should express fundamental differences.

With a view to introducing the student to some of these variations, there will be presented the actual balance sheets and profit and loss statements of three well-known concerns.

*1. Pillsbury Flour Mills Company.* In Figs. 77 and 78, respectively, are reproduced the balance sheet and profit and loss statement of the Pillsbury Flour Mills Company, a Delaware corporation. Below are quoted several paragraphs from the report of the president of the Pillsbury Flour Mills Company, dated July 29, 1939.

Net profit for the year, after providing for interest, taxes, depreciation, and all other expenses, and after deducting extraordinary charges (net) totaling

$365,108.60, amounted to $1,692,317.85. This is equivalent to $3.08 on each share of outstanding capital stock.

Plants and equipment have been kept at maximum efficiency, and provision for depreciation has been made in accordance with the established policy of the Company.

Relations between management and employees have continued on a friendly and satisfactory basis. At May 31, 1939, the Company's employees numbered 3,177.

The strong financial condition of the Company has been maintained and improved. Cash in banks and on hand at the end of the year exceeded the total current liabilities, including the amount of the sinking fund payments to be made within one year on the first mortgage bonds and the amount of the reserve for taxes on income and capital. The ratio of current assets to current liabilities was more than 7.5 to 1. Working capital of the Company at May 31, 1939, as represented by the excess of the current assets over current liabilities, was approximately $13,900,000.

In accordance with the Company's consistent practice in past years, inventories have been valued conservatively, and accounts receivable have been stated at realizable values after making ample allowance for bad debts. The system of internal check and control over inventories and accounts receivable that has been maintained by the Company for many years is believed by the management to be adequate protection against any substantial discrepancies, but as an additional precaution this year, the independent certified public accountants, Touche, Niven & Co., have made physical tests of inventories by count or measurement and have made by direct confirmation more extensive tests than heretofore of accounts receivable.

The reserve for undetermined liabilities arising from invalidation of the processing tax was reduced during the year by $23,850.59, representing principally payments of additional state taxes on income. The total liability for taxes arising from such invalidation has not been finally determined by the government. However, the balance in the reserve (and in the special fund) is believed to be adequate to take care of the unpaid portion, if any, of all liabilities for taxes and other items for which this reserve was created.

As of October 1, 1938, all of the outstanding first mortgage twenty-year 6% gold bonds were called for redemption and redeemed at face amount plus a premium of 2½% in accordance with the provisions of the indenture of mortgage securing said bonds.

On October 1, 1938, the Company issued and sold at private sale at par to The Equitable Life Assurance Society of the United States, $6,000,000 of first mortgage bonds. These bonds were issued under a mortgage and deed of trust by Pillsbury Flour Mills Company to City Bank Farmers Trust Company and Stewart C. Pratt, as Trustees, dated as of September 15, 1938, which authorizes the issuance of $7,500,000 principal amount of bonds, covers certain of the Company's plants, and is conditioned upon terms and provisions deemed by the management to be favorable to the Company. The new bonds that have been issued bear interest at the rate of 3¾% per annum, payable semi-annually on April 1 and October 1, and mature on October 1, 1953. Moderate sinking fund payments are required semi-annually on August 15 and February 15, in varying

**Pillsbury Flour**

BALANCE

**May 31,**

**Assets**

| | | |
|---|---|---|
| CURRENT ASSETS: | | |
| Cash on demand deposit and on hand | | $ 2,443,190.21 |
| U.S. Treasury Bills, at cost (par $3,700,000.00, quoted market price $3,699,850.28) | | 3,700,000.00 |
| Trade accounts receivable | $ 1,808,954.71 | |
| Less reserve for bad debts | 100,000.00 | |
| | | 1,708,954.71 |
| Bill of lading drafts under collection | | 439,951.73 |
| Inventories: | | |
| Wheat and other grain, at market, including adjustment to market of open contracts | $ 4,778,434.54 | |
| Flour, feed, and specialties, at developed cost based on market prices of grain | 1,444,483.13 | |
| Sundry materials, at cost or market, whichever lower | 135,267.54 | |
| Sacks, supplies, etc., at cost or market, whichever lower | 718,012.63 | |
| | | 7,076,197.84 |
| Advances on grain purchases | | 93,612.98 |
| Miscellaneous accounts receivable | $ 612,370.21 | |
| Less reserve for bad debts | 7,106.75 | |
| | | 605,263.46 |
| | | $16,067,170.93 |
| OTHER CURRENT FUNDS—set aside pending settlement of undetermined liabilities, per contra: | | |
| U.S. Treasury Bills, matured—at par | $ 1,100,000.00 | |
| Cash on demand deposit | 14,042.68 | |
| | | 1,114,042.68 |
| PREPAID EXPENSES | | 235,895.92 |
| FIXED PLANT: | | |
| Land, buildings, and equipment, based on appraisal as at August 1, 1922, with subsequent additions at cost, less reserve of $8,210,986.15 for depreciation | | 12,398,092.12 |
| MOVABLE PLANT—vehicles, furniture, and fixtures, at cost less depreciation | | 435,665.64 |
| TRADE MEMBERSHIPS, MISCELLANEOUS INVESTMENTS, ETC., at cost or less | | 102,651.42 |
| HYDRAULIC RIGHTS | | 1.00 |
| GOODWILL, TRADE-MARKS, TRADE NAMES, ETC. | | 1.00 |
| | | $30,353,520.71 |

Fig. 77. Balance Sheet of the

## Mills Company

SHEET

*1939*

### Liabilities

| | | |
|---|---|---|
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued liabilities: | | |
| Trade accounts payable | $ 468,358.89 | |
| Accrued wages and other compensation | 173,087.00 | |
| Property taxes accrued | 137,436.95 | |
| Bond interest accrued | 37,500.00 | |
| Miscellaneous | 191,222.41 | |
| | | $ 1,007,605.25 |
| Dividend payable | | 219,689.60 |
| First Mortgage Bonds, 3¾%, sinking fund payments to be made within one year | | 400,000.00 |
| Reserve for taxes on income and capital | | 500,000.00 |
| | | $ 2,127,294.85 |
| RESERVE FOR UNDETERMINED LIABILITIES ARISING FROM INVALIDATION OF THE PROCESSING TAX | | 1,114,042.68 |
| FUNDED DEBT: | | |
| First Mortgage Bonds, 3¾%, maturing October 1, 1953, with semi-annual sinking fund requirements | $ 6,000,000.00 | |
| Less sinking fund payments to be made within one year | 400,000.00 | |
| | | 5,600,000.00 |
| RESERVES FOR CONTINGENCIES AND COMPENSATION INSURANCE | | 800,000.00 |
| CAPITAL STOCK AND SURPLUS: | | |
| Capital stock: | | |
| Authorized, 800,000 shares of common stock, par value $25.00 per share | | |
| Issued and outstanding, 549,225 shares | $13,730,625.00 | |
| Earned surplus, including balance from predecessor companies (whereof, according to provisions of First Mortgage Bonds indenture, $5,194,454.76 not available for dividends or stock redemption), per accompanying statement | 6,981,558.18 | |
| | | 20,712,183.18 |
| | | $30,353,520.71 |

Pillsbury Flour Mills Company

## Pillsbury Flour Mills Company

### Condensed Profit and Loss and Earned Surplus

**Year Ended May 31, 1939**

| | | |
|---|---|---|
| *Net sales—flour, feed, specialties, and miscellaneous merchandise.* | | 48,928,238.21 |
| *Cost of goods sold and selling, general, and administrative expenses, exclusive of depreciation and maintenance of fixed plant......* | | 44,877,117.01 |
| | | 4,051,121.20 |
| *Miscellaneous deductions, net—inactive plant expense, loss on disposals of fixed plant, etc., $83,076.58; less other income, $18,553.99.......* | | 64,522.59 |
| | | 3,986,598.61 |
| *Interest and amortization of bond discount and expense:* | | |
| *Interest on funded debt.......* | 236,340.00 | |
| *Interest on other obligations.......* | 15,120.97 | |
| *Amortization of bond discount and expense.......* | 8,916.28 | |
| | | 260,377.25 |
| | | 3,726,221.36 |
| *Depreciation and maintenance of fixed plant.......* | | 1,163,474.00 |
| | | 2,562,747.36 |
| *Provision for state taxes on income and taxes on capital........* | | 135,320.91 |
| | | 2,427,426.45 |
| *Provision for federal taxes on income.......* | | 370,000.00 |
| *Net profit before extraordinary charges.......* | | 2,057,426.45 |
| *Extraordinary charges, net:* | | |
| *Unamortized discount and expense, and premium paid, on First Mortgage Twenty-Year Six Per Cent Gold Bonds retired October 1, 1938.......* | 241,669.04 | |
| *Fees, taxes, and other expenses on First Mortgage Bonds, 3¾%, dated October 1, 1938.......* | 88,390.66 | |
| *Loss on dismantling unit of fixed plant.......* | 96,066.10 | |
| | 426,125.80 | |
| *Less credit due to adjustment of reserve for bad debts........* | 61,017.20 | |
| | | 365,108.60 |
| *Net profit for the year.......* | | 1,692,317.85 |
| *Earned surplus, May 31, 1938, including balance from predecessor companies.......* | | 6,167,998.73 |
| | | 7,860,316.58 |
| *Dividends declared.......* | | 878,758.40 |
| *Earned surplus, May 31, 1939, including balance from predecessor companies, per balance sheet.......* | | 6,981,558.18 |

Fig. 78

amounts ranging from \$100,000 to \$200,000 depending in each case upon the amount of the Company's net earnings for the preceding fiscal year.

Part of the proceeds from the sale of the 3¾% bonds was used to redeem the 6% bonds and to pay the expenses incurred in connection with the redemption of the old bonds and the issue of the new bonds, and the remainder was used to increase the Company's working capital.

The balance sheet of the Pillsbury Flour Mills Company is in account form and follows the customary procedure, listing current items first. The current assets are more than 7.5 times the current liabilities which indicates an excellent working capital position. The cash position is also strong, since cash exceeds the entire amount of the current liabilities. In addition, there is an investment of \$3,700,000.00 in U. S. Treasury Bills, which are, of course, a highly liquid asset. Note that a reserve for bad debts of \$100,000.00 is deducted from the trade accounts receivable, while a reserve for bad debts of \$7,106.75 is deducted from miscellaneous accounts receivable. The four items in the inventory are indicative of the nature of the business. The asset, Other Current Funds, equals the Reserve for Undetermined Liabilities on the opposite side of the balance sheet. These are rather unusual items which have been set up on the balance sheet because of liabilities arising from the invalidation of the processing tax. Note that the item Fixed Plant is shown net, that is, less the reserve for depreciation. Intangible assets are listed at \$1.00. The fixed liability, which takes the form of first mortgage bonds, is explained in some detail in the accompanying quotation from the report of the president. The Reserve for Contingencies and Compensation Insurance of \$800,000.00 may or may not be a part of net worth. If it is merely a provision for possible maturing future debts, it is a net worth item, but if it represents an actual liability, it is not. The net worth proper is represented by 549,225 shares of capital stock and an earned surplus of nearly \$7,000,000.00.

The profit and loss statement of the Pillsbury Flour Mills Company is, as its title indicates, a condensed statement. Note that cost of goods sold, together with selling, general, and administrative expenses, are shown as one item amounting to nearly \$45,000,000.00. Financial expenses are deducted separately. Depreciation and maintenance of plant are shown as a separate item. Provision for state taxes and federal taxes is shown as two items. After deducting

**Underwood Elliott**
**(A Delaware**
**and Subsidiary**

CONSOLIDATED

**December 31,**

**Assets**

| | December 31, 1937 | December 31, 1936 |
|---|---|---|
| CURRENT ASSETS: | | |
| Cash in banks and on hand | $ 4,854,475.17 | $ 5,578,153.55 |
| Notes and accounts receivable (employees $21,019.78), less reserves ($290,000.00) | 5,644,860.77 | 5,779,351.75 |
| Inventories of raw materials, goods in process, finished products and supplies, on the basis of cost, or market if lower than cost | 8,979,593.35 | 7,125,724.29 |
| Total current assets | $19,478,929.29 | $18,483,229.59 |
| PREPAID EXPENSES | $ 310,344.53 | $ 265,842.71 |
| FIXED ASSETS: | | |
| Real estate, buildings, plant, machinery, tools, etc. (See footnotes) | $13,560,764.57 | $12,704,532.38 |
| Less reserves for depreciation | 8,183,638.83 | 7,898,512.16 |
| Total fixed assets | $ 5,377,125.74 | $ 4,806,020.22 |
| INVESTMENTS: | | |
| Investments in and advances to subsidiary and affiliated companies not consolidated herein (See footnotes) | $ 4,386,341.48 | $ 4,364,274.20 |
| Other investments (at cost) | 60,000.00 | |
| Total investments | $ 4,446,341.48 | $ 4,364,274.20 |
| PATENTS, DEVELOPMENT, GOODWILL, ETC. | $ 1.00 | $ 1.00 |
| | $29,612,742.04 | $27,919,367.72 |

Consolidated statements are prepared on the principle of including all domestic subsidiary companies and all other subsidiaries engaged in the manufacture of the Company's product.

Investments in wholly-owned non-consolidated subsidiary companies have been adjusted as at November 30, 1937, the close of the fiscal year of the subsidiaries, to agree with their respective financial statements. Where foreign currencies are involved, these investments are carried at the former gold parity of the appropriate foreign exchanges or at the rate prevailing at the close of the year, whichever is lower. The equity of the Company in such wholly-owned non-consolidated subsidiaries has been increased since acquisition as a result of profits not distributed by the net amount of $1,715,741.92.

Investments in subsidiary companies not wholly-owned are carried at cost. Where such investments are in a country from which the withdrawal of funds is prohibited or

Fig. 79. Consolidated Balance Sheet of

**Fisher Company**
**Corporation)**
**Companies**

BALANCE SHEET

1937

| Liabilities | December 31, 1937 | December 31, 1936 |
|---|---|---|
| CURRENT LIABILITIES: | | |
| Accounts payable | $ 400,501.05 | $ 594,265.10 |
| Accrued wages, commissions, etc. | 432,810.06 | 474,971.83 |
| Accrued taxes | 1,247,013.67 | 831,216.01 |
| Unredeemed merchandise coupons | 80,630.99 | 77,034.50 |
| Total current liabilities | $ 2,160,955.77 | $ 1,977,487.44 |
| DEFERRED LIABILITIES | $ 50,000.00 | $ 60,000.00 |
| DEFERRED INCOME | $ 47,118.05 | $ 42,917.04 |
| RESERVES FOR CONTINGENCIES AND FUTURE EXPENDITURES, as per accompanying statement | $ 6,068,822.07 | $ 6,167,602.38 |
| CAPITAL STOCK AND SURPLUS: | | |
| Common stock of no par value: | | |
| Shares | | |
| Authorized ... 1,000,000 | | |
| Issued ... 763,479 | | |
| In treasury ... 30,395 | | |
| Outstanding ... 733,084 | $ 7,330,840.00 | $ 7,330,840.00 |
| EARNED SURPLUS, as per accompanying statement | 13,955,006.15 | 12,340,520.86 |
| Total capital stock and surplus | $21,285,846.15 | $19,671,360.86 |
| | $29,612,742.04 | $27,919,367.72 |

seriously impeded on account of governmental restrictions, the Company carries adequate reserves created out of surplus, which will be available if required.

All inter-company profits in inventories of subsidiary companies, whether consolidated or not consolidated, have been eliminated in consolidation or provided for by reserves.

The basis at which fixed assets are carried is the cost of acquisition to the individual companies. Fixed assets include property at vacated plant in the net amount of $327,705.13. No depreciation has been provided since 1933 on plant and equipment rendered idle by the 1933 consolidation of manufacturing operations and not reconverted into use, but ample reserves (included in general reserves for contingencies) have been set up out of earned surplus to cover any possible loss in connection with their maintenance and disposition.

the Underwood Elliott Fisher Company

certain extraordinary charges, the net profit for the year is shown as $1,692,317.85. This item of net profit may be regarded as the conclusion of the profit and loss statement. The balance of the statement is a summary of the earned surplus account. The surplus is increased by the net profit for the year and decreased by the amount of dividends declared.

2. *Underwood Elliott Fisher Company.* In Figs. 79 and 80, respectively, are shown the balance sheet and profit and loss statement of the Underwood Elliott Fisher Company. Below are quoted several paragraphs from the report of the President, dated February 15, 1938.

> Cash was $4,854,475.17 on December 31, 1937, after payment during 1937 of common dividends aggregating $3,298,878.00, compared with cash of $5,578,153.55 on December 31, 1936, after payment during 1936 of dividends aggregating $2,143,805.07.
>
> Net current assets were $17,317,973.52 on December 31, 1937, compared with $16,505,742.15 on December 31, 1936.
>
> Notes and accounts receivable have been carefully analyzed, and, after deducting reserves of $290,000.00, are carried at the net figure of $5,644,860.77.
>
> Inventories have been valued on the basis of cost, or market if lower than cost, and are carried at the net figure of $8,979,593.35.
>
> Fixed assets less depreciation reserves are carried at the net figure of $5,377,125.74. . . .
>
> Your company has no funded debt or notes payable. . . .
>
> The balance of $13,955,006.15 in the consolidated statement of surplus is earned surplus. . . .
>
> Our program for improvement of manufacturing methods and equipment was continued throughout 1937. In excess of $1,000,000 was expended for capital assets, some of the principal items of which were:
>
> 1. Additions to machinery and equipment at all Works for more economical and efficient manufacturing.
> 2. A new power distributing system for the Hartford Works, including new substations, electrical apparatus and wiring for the economical use of power.
> 3. Modern japanning equipment, which when completed will cost approximately $100,000, utilizing the latest methods of finishing products in the various lacquer and japan finishes used today, with the most improved provisions for the safety of employees.

## Underwood Elliott Fisher Company and Subsidiary Companies

### Consolidated Statement of Income

**For Year 1937**

| | | 1937 | | 1936 |
|---|---|---|---|---|
| *Gross sales and services, less discounts, returns and allowances.* | | 30,767,443.41 | | 27,312,196.65 |
| *Net results of operations for year after deducting manufacturing, selling and general expenses and all other charges, but before deduction of the charges for taxes and depreciation set forth below; including net operating results of wholly owned non-consolidated subsidiary companies....* | | 6,798,922.39 | | 4,962,413.23 |
| *Deduct provisions for:* | | | | |
| *Federal taxes on income and capital................* | 854,512.50 | | 493,837.70 | |
| *Surtax on undistributed profits.* | 65,000.00 | | | |
| *Social security taxes—federal and state...............* | 482,398.40 | | 146,689.05 | |
| | 1,401,910.90 | | 640,526.75 | |
| *Depreciation..............* | 483,648.20 | | 483,182.44 | |
| | | 1,885,559.10 | | 1,123,709.19 |
| *Net income for year...........* | | 4,913,363.29 | | 3,838,704.04 |
| *Earnings per share of Common Stock outstanding..........* | | 6.70 | | 5.06 |

Dividends received from non-consolidated subsidiaries are applied in reduction of the investments therein and are not included in income. Where foreign currencies are involved, their earnings are converted at the former gold parity of the appropriate foreign exchanges or at the rate prevailing at the close of the year, whichever is lower. Earnings of subsidiaries, the availability of which is seriously curtailed by exchange or other restrictions, are not included.

Gross sales exclude sales to subsidiaries included in the consolidated balance sheet and include sales to subsidiaries not so consolidated; but inter-company profits on transactions with subsidiaries, whether consolidated or not consolidated, to the extent unrealized through sales by the subsidiaries, have been excluded from the consolidated income.

The Company maintains a policy of providing out of current income, in the discretion of the management, reserves for anticipated or possible future expenses or adjustments.

Full depreciation at the uniform rates established in 1933 has been charged on active facilities (except those fully provided for in depreciation reserves). No depreciation has been charged to income on plant or equipment rendered idle by the 1933 consolidation of manufacturing operations and not reconverted into use.

Fig. 80

**Devoe & Raynolds Company, Inc., and Subsidiaries**

CONSOLIDATED BALANCE SHEET

**as at November 30, 1937**

*Assets*

| | | |
|---|---|---|
| Land, Buildings, Machinery and Operating Equipment—at cost | | $ 6,683,106.41 |
| Less Reserve for Depreciation | | 3,164,254.31 |
| | | $ 3,518,852.10 |
| Investments and Advances (non-current): | | |
| Investment in minor subsidiaries not consolidated—at cost (equity as reported by such subsidiaries $76,960.52) | $ 67,554.33 | |
| Cash Surrender Value of Life Insurance Policies | 43,042.63 | |
| Miscellaneous Investments and Advances | 91,702.14 | |
| | | 202,299.10 |
| Current Assets: | | |
| Cash in Banks and on Hand | $ 865,373.54 | |
| Notes Receivable—Customers | 132,572.39 | |
| Accounts Receivable — Customers, less Reserve | 1,901,970.64 | |
| Miscellaneous Accounts Receivable | 38,404.14 | |
| Merchandise, Materials and Supplies—at cost (not in excess of market) | 4,230,585.88 | |
| | | 7,168,906.59 |
| Prepaid Expenses and Deferred Charges | | 344,953.45 |
| | | $11,235,011.24 |

*Liabilities*

| | | |
|---|---|---|
| Capital Stock: | | |
| 7% Cumulative Preferred Stock, Par $100.00: Authorized and Issued, 8,940 shares | | $ 894,000.00 |
| Common—No-Par Value: | | |
| Class "A"—Authorized, 235,000 shares; Issued, 95,000 shares | | 3,539,745.83 |
| Class "B"—Authorized and Issued, 40,000 shares | | 1,333,333.33 |
| | | $ 5,767,079.16 |
| Current Liabilities: | | |
| Notes Payable—Banks | $1,900,000.00 | |
| Accounts Payable and Accrued Expenses | 551,471.90 | |
| Provision for Federal Income Tax | 107,704.28 | |
| | | 2,559,176.18 |
| Reserve for Contingencies (unchanged during year) | | 186,404.97 |
| Earned Surplus | | 2,722,350.93 |
| | | $11,235,011.24 |

Fig. 81

**Accountants' Report**

To the Board of Directors,
Devoe & Raynolds Company, Inc.,
New York, N. Y.

We have made an examination of the Consolidated Balance Sheet of Devoe & Raynolds Company, Inc. and subsidiaries as at November 30, 1937, and of the Consolidated Profit and Loss and Earned Surplus Accounts for the year then ended. In connection therewith, we examined or tested accounting records of the Companies and other supporting evidence and obtained information and explanations from officers and employees of the Companies; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying Consolidated Balance Sheet and related Consolidated Profit and Loss and Earned Surplus Accounts fairly present, in accordance with accepted principles of accounting consistently maintained by the Companies during the year under review, their consolidated position at November 30, 1937, and the results of their operations for the year.

*New York, N. Y.,*
*January 22, 1938.*

**Peat, Marwick, Mitchell & Co.**

Fig. 81—Concluded

The balance sheet of the Underwood Elliott Fisher Company is in comparative form. The working capital position is very strong, cash on hand being much in excess of total current liabilities. The use of footnotes to explain the balance sheet is followed. The student will do well to examine these footnotes, relating them to the items in the balance sheet which they clarify. The Consolidated Statement of Income for the Year is also in comparative form and highly condensed. Here again, the use of footnotes to explain the statement is practiced.

### Consolidated Profit and Loss Account

**For the Year Ended November 30, 1937**

| | | |
|---|---|---|
| *Gross Sales, less returns and allowances* | | 12,356,366.01 |
| *Cost of Sales, Warehouse, Shipping, Selling and General Expenses, exclusive of maintenance, repairs and depreciation* | 11,356,767.44 | |
| *Maintenance and Repairs* | 67,632.00 | |
| *Depreciation of Plant and Equipment* | 128,325.15 | |
| | | 11,552,724.59 |
| *Net Operating Profit* | | 803,641.42 |
| *Miscellaneous Charges (net)—discounts, interest, etc.* | | 118,958.26 |
| *Net Income before Federal Taxes* | | 684,683.16 |
| *Provision for Federal Income Tax (Surtax not assessable)* | | 75,000.00 |
| *Net Income* | | 609,683.16 |

Fig. 82

3. *Devoe & Raynolds Company, Incorporated.* In Figs. 81 and 82, respectively, are shown the balance sheet and profit and loss statement of the Devoe & Raynolds Company, Incorporated. In the balance sheet of this company, fixed assets are placed first on the asset side, and capital stock is placed first on the liability side. This arrangement is less common than that wherein current assets and current liabilities are placed at the top of the balance sheet. The working capital position is good, but the ratio of current assets to current liabilities is not as favorable as in the case of the Pillsbury Flour Mills Company (Fig. 77) or as in the case of the Underwood

Elliott Fisher Company (Fig. 79). Note in particular the unusual treatment of earned surplus, which is placed at the bottom of the liability side of the balance sheet, instead of being placed immediately below the capital stock, which is the customary procedure. The accountants' report, in brief form, is placed under the balance sheet as shown in Fig. 81.

# *Chapter* 9

# SPECIAL JOURNALS AND CONTROLLING ACCOUNTS

**Limitations of General Journal.** Thus far the only form of journal which has been considered is the general journal. In it all entries have been made, including routine transactions of all kinds as well as adjusting, closing, and post-closing entries. It might be possible in practice to enter all transactions in one journal in case of a small business. In practically all cases, however, it is desirable to use more than one journal. The reason for this is because there occur many transactions of a similar character, such as (*a*) sales on account, (*b*) purchases for cash, (*c*) purchases on account, (*d*) sales for cash, (*e*) cash receipts, (*f*) cash disbursements. Where there are many transactions of essentially similar character, it becomes possible to save a great deal of work by providing a special form of journal for recording them. For example, if there are many purchases during the month, it becomes a burdensome task to repeat in the journal the word *purchases* for each purchase. Similarly it may become a serious task to repeat the word *cash* in case of cash receipts or the word *cash* in case of cash payments.

In all such cases, a point is reached where it becomes desirable to operate one or more *Special Journals*. A special journal is one in which the debits or the credits, as the case may be, are all to the same account; thus a special journal for purchases is one in which the only debits made are to the Purchases account, and a special journal for sales is one in which all credits are made to the Sales account.

**Accounting for Sales.** Sales may be made either on account or for cash. If a sale is made to A. B. Gray on account, terms 2/10, n/30, the entry therefor on a general journal is as follows:

| | | |
|---|---|---|
| *A. B. Gray* | *60.00* | |
| *Sales* | | *60.00* |
| *Terms 2/10, n/30.* | | |

If a sale is made for cash, the entry therefor in the general journal is as follows:

| | | |
|---|---|---|
| *Cash* | *40.00* | |
| *Sales* | | *40.00* |
| *For cash sales.* | | |

For every sale on account, the word *sales* is credited. If during a given month a concern makes 1,600 credit sales the word *sales* must be repeated 1,600 times if the entry for each sale is made in the general journal.

It is evident that if all sales on account could be made in a book intended only for sales on account the necessity of repeating the word *sales* would be removed, since it would be known, upon adding the items in this book, that the total thereof represents only sales made on account. Cash sales also may be so numerous that to enter each cash sale in the general journal would become extremely burdensome. Moreover, as will be seen shortly, the need of special journals to record cash receipts and cash payments soon becomes evident in business.

**Accounting for Purchases.** Purchases may be made either on account or for cash. Assume that a purchase is made from the Sun Wholesale Company on account, terms 2/10, n/60. The entry therefor on a general journal is as follows:

| | | |
|---|---|---|
| *Purchases* | *100.00* | |
| *Sun Wholesale Co* | | *100.00* |
| *Terms 2/10, n/60.* | | |

If a purchase is made for cash, the entry therefor in the general journal is as follows:

| | | |
|---|---|---|
| *Purchases* | *90.00* | |
| *Cash* | | *90.00* |
| *For cash purchase of merchandise.* | | |

If there are many purchases on account, there will occur the constant repetition of the word *purchases* and, likewise, if there are many purchases for cash, there will occur the constant repetition of the word *cash.*

Just as it becomes desirable to record numerous sales on account in a special book, so it becomes desirable to record numerous purchases on account in a special book, in order that the necessity of

constantly repeating the word *purchases* may be avoided. Thus, if nothing but purchases on account are entered in a given book, it is evident that the total of all of the transactions entered in such book represents the debit to be made to the Purchases account.

In accounting for sales, it is possible to eliminate the repetition of the word *sales* by using a book in which only sales on account are credited and in accounting for purchases it is possible to avoid repetition of the word *purchases* by entering all purchases on account in a special book. To illustrate the principle involved, assume that sales on account are made to A. B. Gray for $60.00, to John R. Lott for $20.00, and to A. Morgan for $35.00. As a step in the development of a record for sales on account, these items may be listed as follows:

| | |
|---|---|
| *A. B. Gray* | 60.00 |
| *John R. Lott* | 20.00 |
| *A. Morgan* | 35.00 |
| *Sales* | 115.00 |

The listing of sales, as shown above, may be regarded as the essential step in the devising of a form for a sales journal. The debit to each customer and the credit to sales can easily be derived from the information shown in this listing. Below will be shown the necessary form for the recording of sales.

Again assume that purchases on account are made from James A. Rett for $150.00, L. B. Burns for $100.00, and K. A. Morton for $50.00. The essential facts may be shown by listing these transactions as follows:

| | |
|---|---|
| *James A. Rett* | 150.00 |
| *L. B. Burns* | 100.00 |
| *K. A. Morton* | 50.00 |
| *Purchases* | 300.00 |

It is evident that the three credits to the individuals from whom purchases are made is offset by the single debit to Purchases account. All of the essential information may be derived from the foregoing listing, but it is practicable to use a properly ruled purchases journal, such as will be illustrated later.

**Accounting for Cash.** Cash receipts and disbursements are usually so numerous that it is impracticable to enter them in the general journal. Special records must be devised for recording both

cash receipts and disbursements. The debit to cash receipts for a given period is usually offset by credits to several or even many accounts; likewise, the credit to cash for a given period may be offset by debits to many different accounts.

As a simple illustration of cash receipts, assume that in a given period of time cash is received as follows: James Arthur on account \$30.00, Interest Income \$60.00, Dividend on Stock owned \$120.00, L. T. West on account \$10.00, Cash Sales \$175.00. This information may be organized to show essential facts by listing as follows:

| | |
|---|---|
| *James Arthur on Account* | *30.00* |
| *Interest Income* | *60.00* |
| *Dividend on Stock Owned* | *120.00* |
| *L. T. West on Account* | *10.00* |
| *Cash Sales* | *175.00* |
| *Cash Receipts* | *395.00* |

From the foregoing tabulation, it is possible to secure all information necessary for posting, the credits being to the individual items, and the debits being for the total of cash receipts. However, it is desirable to prepare a special form of the journal in which all cash receipts can be entered and an analysis made of all corresponding credits. This will be explained later in this chapter.

As an illustration of cash disbursements, assume that in a given period of time cash is paid out as follows: Sun Wholesale Company on account \$200.00, Interest Expense \$37.50, Repairs \$15.00, Purchase of Merchandise \$70.00, Furniture and Fixtures \$80.00, Prepaid Insurance \$120.00. This information may be organized to show essential facts by listing as follows:

| | |
|---|---|
| *Sun Wholesale Co. on Account* | *200.00* |
| *Interest Expense* | *37.50* |
| *Repairs* | *15.00* |
| *Purchase of Merchandise* | *70.00* |
| *Furniture and Fixtures* | *80.00* |
| *Prepaid Insurance* | *120.00* |
| *Cash Disbursements* | *522.50* |

**Sales Journal.** To illustrate the use of the sales journal, three sales transactions will be entered first in the standard or general journal form. These transactions are given below, and the journal in which they are entered is shown in Fig. 83. Sell to A. L. Bordon

on account $16.00, terms 2/10, n/30, sell to B. K. Arthur on account $30.00, terms 2/10, n/30, sell to B. A. Martin on account $6.00, terms 2/10, n/60.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| *Jan.* | 2 | *A. L. Bordon* | | 16 | 00 | | |
| | | *Sales* | | | | 16 | 00 |
| | | *Sold on account, 2/10, n/30* | | | | | |
| | 3 | *B. K. Arthur* | | 30 | 00 | | |
| | | *Sales* | | | | 30 | 00 |
| | | *Sold on account, 2/10, n/30* | | | | | |
| | 5 | *B. A. Martin* | | 6 | 00 | | |
| | | *Sales* | | | | 6 | 00 |
| | | *Sold on account, 2/10, n/60* | | | | | |

Fig. 83

In Fig. 84, these same transactions are entered in a Special Sales Journal. It should be noted that the repetition of the word *sales* is avoided. This is made possible because only sales on account are entered in the sales journal. This elimination of the word sales from the individual entry cannot be made in the general journal, because in that journal entries for sales are interspersed with other types of entries. The saving in labor and space afforded in the sales journal is made possible because all entries, except entries for sales on account, are eliminated.

**Sales Journal**

| 1 | 2 | 3 | 4 | 5 | 6 | |
|---|---|---|---|---|---|---|
| *Jan.* | 2 | *A. L. Bordon* | *2/10, n/30* | | 16 | 00 |
| | 3 | *B. K. Arthur* | *2/10, n/30* | | 30 | 00 |
| | 5 | *B. A. Martin* | *2/10, n/60* | | 6 | 00 |

Fig. 84

In the sales journal (Fig. 84) the first column is for the month, the second column for the day of the month, the third column for the name of the customer, the fourth column for terms, the fifth column is the folio column, the use of which will be explained later, and the sixth column is for the amount. At any time the total of sales to date can be ascertained by adding the amount for which customers are charged.

In Fig. 85 is shown a form of sales returns journal. The purpose of this journal is to record the return of merchandise by customers. This may be because the merchandise is unsatisfactory or because it is defective.

**Sales Returns Journal**

| 1 | 2 | 3 | 4 | 5 | 6 | |
|---|---|---|---|---|---|---|
| *Jan.* | *4* | *A. L. Bordon* | | | *4* | *00* |
| | *6* | *B. K. Arthur* | | | *1* | *50* |
| | *9* | *B. A. Martin* | | | | *75* |

Fig. 85

**Purchase Journal.** To illustrate the use of the Purchase Journal, three purchase transactions are entered in the standard or general journal in Fig. 86. These transactions are as follows: purchase from L. K. Morrison on account $25.00, terms 2/10, n/30, purchase from M. L. Kramer on account $80.00, terms 2/10, n/60, purchase from M. M. White $200.00 on account, terms 2/10, n/60.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| *Jan.* | *3* | *Purchases* | | | *25* | *00* | | |
| | | *L. K. Morrison* | | | | | *25* | *00* |
| | | *Purchased on account* | *2/10, n/30* | | | | | |
| | *5* | *Purchases* | | | *80* | *00* | | |
| | | *M. L. Kramer* | | | | | *80* | *00* |
| | | *Purchased on account* | *2/10, n/60* | | | | | |
| | *6* | *Purchases* | | | *200* | *00* | | |
| | | *M. M. White* | | | | | *200* | *00* |
| | | *Purchased on account* | *2/10, n/60* | | | | | |

Fig. 86

In Fig. 87 these same transactions are entered in a special purchase journal. In doing so the repetition of the word *purchases* is avoided, because only purchases on account are entered in this journal. It was impossible to eliminate the word purchases in the general journal in Fig. 86 because entries for other transactions than purchases are made in the general journal; thus, the same saving of labor and space is accomplished by setting up the purchase journal as is accomplished by the use of a sales journal.

**Purchase Journal**

| 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|
| *Jan.* | *3* | *L. K. Morrison* | *2/10, n/30* | | *25 00* |
| | *5* | *M. L. Kramer* | *2/10, n/60* | | *80 00* |
| | *6* | *M. M. White* | *2/10, n/60* | | *200 00* |

Fig. 87

In the purchase journal, Fig. 87, the first column is for the month, the second column is for the day of the month, the third column for the name of the creditor, the fourth column for terms, the fifth column is the folio column, and the sixth column is for the amount. The total purchases on account to date may be found at any time by adding the amount column.

In Fig. 88 is shown a form of Purchase Returns Journal. The purpose of this journal is to record the return of merchandise to the creditors where the goods proves defective or is found to be unsatisfactory.

**Purchase Returns Journal**

| 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|
| *Jan.* | *5* | *M. L. Kramer* | | | *5 00* |

Fig. 88

**Cash Journal.** A Cash Journal is a book so ruled as to permit the entry of all cash receipts on the left-hand side of the book and all cash payments on the right-hand side of the book. In Fig. 89 is shown the simplest possible form of a cash journal.

The cash journal, shown in Fig. 89, possesses certain limitations which are likely to make it undesirable, except in case of small concerns. The total amount to be debited to cash is easily determined by simply adding column 4 on the left-hand side of the form. Likewise, the total amount to be credited to cash is found by adding column 4 on the right-hand side of the form. The chief objection to the form is that credit items appearing on the left-hand side must be posted in detail; thus each *Sales* item must be posted to the Sales account in the ledger. For the same reason all debits shown on the right-hand side of the form must be posted in detail. It will be noted

**Cash Journal**

| 1 | | 2 | 3 | 4 | | 1 | | 2 | 3 | 4 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | *1* | *C. D. Mayer, Net Worth* | *1* | *8,000* | *00* | *Jan.* | *1* | *Rent* | *10* | *90* | *00* |
| | *1* | *Sales* | *3* | *15* | *00* | | *2* | *Advertising* | *11* | *9* | *75* |
| | *2* | *Sales* | *3* | *7* | *95* | | *3* | *Wages* | *12* | *25* | *75* |
| | *3* | *Sales* | *3* | *37* | *50* | | *3* | *Salaries* | *13* | *35* | *50* |
| | *4* | *B. M. Mark* | *CL4* | *25* | *95* | | *4* | *Auto Truck* | *14* | *675* | *95* |
| | *5* | *Sales* | *6* | *17* | *50* | | *5* | *Furniture and Fixtures* | *15* | *790* | *50* |
| | *6* | *Sales* | *7* | *9* | *75* | | *5* | *Sun Wholesale Co.* | *CL3* | *59* | *75* |
| | *7* | *M. Sander* | *CL9* | *5* | *75* | | | | | | |
| | | *Cash Debit* | *2* | *8,119* | *40* | | | *Cash Credit* | *2* | *1,687* | *20* |
| | | | | *8,119* | *40* | *Jan.* | *9* | *Balance* | | *6,432* | *20* |
| | | | | | | | | | | *8,119* | *40* |
| *Jan.* | *9* | *Balance* | | *6,432* | *20* | | | | | | |

Fig. 89

that the folio number of two items on the left-hand side of the form are preceded by the letters CL (for customers' ledger) and similarly one item on the right-hand side is preceded by the letter CL (for creditors' ledger). This is because it becomes necessary in connection with the operation of special journals, such as the purchase journal and the sales journal, to carry the accounts of creditors and customers in separate ledgers, which frequently are called subsidiary ledgers. Later in this chapter, the operation of subsidiary ledgers in connection with special journals and their relation to the general ledger will be explained.

The manner in which the cash journal, shown in Fig. 89, is ruled up and the balance brought down should be noted carefully. Note that the total of cash receipts, namely, $8,119.40, is posted to the debit side of Cash account on page 2 in the ledger and that the total of cash payments, $1,687.20, is posted to the credit side of the Cash account on page 2 in the ledger. The balance of the account is the excess of cash receipts over cash payments, or $6,432.20. This is placed immediately under the total of cash payments and is brought down on the left-hand side of the account underneath the double ruling. This amount represents the balance of cash on hand on January 9.

It will be noted that the cash journal, shown in Fig. 89, is in itself a kind of cash account. It should not be confused with the Cash

account in the ledger to which are posted simply the totals of receipts and disbursements.

Since the cash journal, shown in Fig. 89, is likely to prove inadequate because it does not provide for sufficient analysis of either cash receipts or cash payments, it will be necessary to devise forms of the cash journal which will be serviceable for larger enterprises. In Fig. 90 is shown another form of the cash journal in which are entered the same transactions as were entered in the cash journal shown in Fig. 89.

In Fig. 90 considerable analysis is provided for both cash receipts and cash disbursements. All receipts for cash sales are entered in the cash sales column. All receipts from customers are entered in the Customers Cr. column. Immediately preceding the Customers Cr. column is the A.R.L.F. (accounts receivable ledger folio) column in which is indicated the page of the subsidiary accounts ledger to which the item is posted. Miscellaneous cash receipts are entered in the Sundries Cr. column and when the cash journal is footed the total of cash sales is carried into the Sundries column, from which it is posted to the general ledger. Likewise, the total of the Customers column is carried to the Sundries column, from which it is posted to the general ledger account entitled either Customers account or Accounts Receivable account.

On the right-hand side of Fig. 90, a special column is provided for wages and a special column for creditors. The items in the Creditors Dr. column are posted to the subordinate creditors or accounts payable ledger. The total of this column is carried into the Sundries column and from there posted to the Creditors or Accounts Payable account in the general ledger. The total of the Wages column is also carried into the Sundries Dr. column and posted to the Wages account in the general ledger. The items carried directly to Sundries Dr. column are posted individually to the general ledger. The total of cash receipts is posted to the debit side of the Cash account from the Sundries Cr. column and the total of the cash sales is posted to the Cash account in the general ledger from the Sundries Dr. column. Note that the cash journal is balanced, the balance being carried down on the left-hand side and the totals ruled up.

**C. D. Mayer**

CASH JOURNAL

| Date | | Explanation | Cash Sales | A.R. L.F. | Customers, Cr. | G.L. F. | Sundries, Cr. | Date | | Explanation | Wages | A.P. L.F. | Creditors, Dr. | G.L. F. | Sundries, Dr. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | 19— | | | | | | | |
| *Jan.* | 1 | *C.D. Mayer, N.W.* | | | | 1 | 8,000 00 | *Jan.* | 1 | *Rent* | | | | 10 | 90 00 |
| | 1 | *Sales* | 15 00 | | | | | | 2 | *Advertising* | | | | 11 | 9 75 |
| | 2 | *Sales* | 7 95 | | | | | | 3 | *Wages* | 25 75 | | | 12 | |
| | 3 | *Sales* | 37 50 | | | | | | 3 | *Salaries* | | | | 13 | 35 50 |
| | 4 | *B. M. Mark* | | 4 | 25 95 | | | | 4 | *Auto Truck* | | | | 14 | 675 95 |
| | 5 | *Sales* | 17 50 | | | | | | 5 | *Furniture and* | | | | | |
| | 6 | *Sales* | 9 75 | | | | | | | *Fixtures* | | | | 15 | 790 50 |
| | 7 | *M. Sander* | | 9 | 5 75 | | | | 5 | *Sun Wholesale Co.* | | 3 | 59 75 | | |
| | | *Sales, Cr.* | 87 70 | | | 3 | 87 70 | | | *Wages, Dr.* | 25 75 | | | 16 | 25 75 |
| | | *Customers, Cr.* | | | 31 70 | 5 | 31 70 | | | *Creditors, Dr.* | | | 59 75 | 17 | 59 75 |
| | | *Cash, Dr.* | | | | 2 | 8,119 40 | | | | | | | | |
| | | | | | | | | | | *Cash, Cr.* | | | | | 1,687 20 |
| *Jan.* | 8 | *Balance* | | | | | 6,432 20 | | | *Balance* | | | | | 6,432 20 |
| | | | | | | | | | | | | | | | 8,119 40 |

Fig. 90

The next step in the development of cash records is to provide separate journals for cash receipts and cash disbursements. In Fig. 91 is shown a Cash Receipts Journal, and in Fig. 92 is shown a Cash Payments Journal. The same entries are made as in the preceding illustrations.

**C. D. Mayer**

CASH RECEIPTS JOURNAL

| Date | | Explanation | Bank, Dr | A.R. L F. | Cash Sales, Cr | Customers, Cr | G L F | Sundries, Cr. |
|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | |
| *Jan.* | *1* | *C. D Mayer, Net Worth* | *8,000 00* | | | | *1* | *8,000 00* |
| | *1* | *Sales* | *15 00* | | *15 00* | | | |
| | *2* | *Sales* | *7 95* | | *7 95* | | | |
| | *3* | *Sales* | *37 50* | | *37 50* | | | |
| | *4* | *B M Mark* | *25 95* | *4* | | *25 95* | | |
| | *5* | *Sales* | *17 50* | | *17 50* | | | |
| | *6* | *Sales* | *9 75* | | *9 75* | | | |
| | *7* | *M. Sander* | *5 75* | *9* | | *5 75* | | |
| | | | *(7) 8,119 40* | | *(3) 87 70* | *(5) 31 70* | | *(√)8,000 00* |

Fig 91

**C. D. Mayer**

CASH PAYMENTS JOURNAL

| Date | | Explanation | Bank, Cr. | A.P L.F. | Creditors Dr. | Wages, Dr. | Advertising, Dr. | G. L. F. | Sundries, Dr. |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan* | *1* | *Rent* | *90 00* | | | | | *10* | *90 00* |
| | *2* | *Advertising* | *9 75* | | | | *9 75* | | |
| | *3* | *Wages* | *25 75* | | | *25 75* | | | |
| | *3* | *Salaries* | *35 50* | | | | | *13* | *35 50* |
| | *4* | *Auto Truck* | *675 95* | | | | | *14* | *675 95* |
| | *5* | *Furniture and Fixtures* | *790 50* | | | | | *15* | *790 50* |
| | *5* | *Sun Wholesale Co* | *59 75* | *3* | *59 75* | | | | |
| | | | *(6)1,687 20* | | *(3)59 75* | *(16) 25 75* | *(11) 9 75* | | *(15) 1,591 95* |

Fig. 92

**Controlling Accounts.** The operation of a special purchase journal, a special sales journal, a special return purchase journal, a

special return sales journal, a cash receipts journal containing a column for *customers*, and a cash payments journal containing a column for *creditors* makes it possible to follow the procedure of setting up special *Customers* or *Accounts Receivable Ledgers* and special *Creditors* or *Accounts Payable Ledgers*. When this is done, there appears in the general ledger a so-called controlling account entitled either Customers Controlling account or Accounts Receivable Controlling account and a controlling account entitled either Creditors Controlling account or Accounts Payable Controlling account. It is immaterial whether in connection with such a plan of accounting the terms *customers* and *creditors* or the terms *accounts receivable* and *accounts payable* are used. It is simply desirable to follow a uniform scheme of terminology. Thus, if there is in the cash receipts journal a Customers column the subordinate ledger in which accounts for customers are kept should be called a *Customers Ledger*. Likewise, if in a cash payments journal there appears a column for *creditors*, the corresponding subordinate ledger in which accounts for creditors are kept should be called a *Creditors Ledger*.

The subordinate customers ledger and the subordinate creditors ledger may be kept on standard ledger forms, or special forms may be provided for these special ledgers. In practice, it is usually desirable to provide special forms which afford greater convenience than is provided by the usual general ledger form. In a subordinate ledger are kept accounts of one kind only; thus, in the customers ledger are kept only accounts with customers and in the creditors ledger are kept only accounts with creditors. This makes it possible to keep in the general ledger a Customer Controlling account which contains a summary of the details shown in the subordinate customers ledger. It also makes it possible to keep in the general ledger a Creditors Controlling account which likewise contains a summary of the details shown in the creditors ledger.

If the special journals are properly arranged, it will be possible to post from each special journal to the proper subordinate ledger all details affecting the accounts kept therein and to post to the proper controlling account in the general ledger an amount equal to the total of the details posted to the subordinate ledger. In other words, the debit to the controlling account posted at the end of the

accounting period is equal to the sum of the detailed debits carried to the subordinate ledger and the credit carried to the controlling account at the end of the accounting period is equal to the sum of the credits carried to the accounts in the subordinate ledger.

After all postings have been made to the controlling account and to the subordinate ledger, the balance of the controlling account should equal the sum of the balances of the accounts in the subordinate ledger. If there is a difference, it is due to an error which must be located. It should be noted carefully that the amounts posted to the controlling account must be determined *independently* of the amounts which are posted to the subordinate ledger. The items posted to the subordinate ledger cannot be added up in this ledger and then entered in the controlling account. The amount posted to the controlling account must be posted from the proper special journal. To illustrate, suppose that the purchase journal contains the following items:

| | | | |
|---|---|---|---|
| *John Jones* | *7* | *40* | *00* |
| *Arthur Allen* | *3* | *10* | *00* |
| *B. C. Morris* | *18* | *20* | *00* |
| *Creditors, Cr.* | *GL12* | | |
| *Purchases, Dr.* | *GL17* | *70* | *00* |

The first posting to be made to the subordinate creditors ledger is $40.00, which is credited to the account of John Jones. If his account is on page 7 of the subordinate creditors ledger, then 7 must be placed in the folio column preceding the amount in the purchase journal. If Arthur Allen's account is on page 3 of the subordinate creditors ledger, then the amount $10.00 is posted to the credit side of his account on page 3 and the page of the ledger is entered in the folio column of the purchase journal preceding the amount. The item for B. C. Morris is posted likewise. If his account is on page 18 of the creditors ledger, that number is placed in the folio column.

The posting of the total of $70.00 now deserves attention. This is carried to the credit side of the Creditors Controlling account in the general ledger, say, on page 12. Twelve is now entered in the folio column of the purchase journal as shown above, and the word *Creditors* is written in the explanation column as shown above. After these accounts are posted, the three accounts in the creditors ledger

will appear as shown in Fig. 93, and the Creditors Controlling account will appear as shown in Fig. 94. It is assumed that the entries shown above are entered on page 1 of the purchase journal.

**Arthur Allen** Page 3

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | *PJ1* | *10 00* |

**John Jones** Page 7

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | *PJ1* | *40 00* |

**B. C. Morris** Page 18

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | *PJ1* | *20 00* |

Fig. 93

**Creditors Control** Page 12

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | *PJ1* | *70 00* |

Fig. 94

In order to carry the illustration one step farther, assume that payment in full of Arthur Allen's account is made, that $20.00 is paid to John Jones on account, and that $5.00 is paid to B. C. Morris on account. These entries appear in the cash payments journal as shown in Fig. 95.

**Cash Payments Journal** Page 1

| | Bank, Cr. | A.R. L.F. | Creditors, Dr. | Wages, Dr. | Advertising, Dr. | G.L. F. | Sundrie Dr. |
|---|---|---|---|---|---|---|---|
| *Arthur Allen* ........ | *10 00* | *3* | *10 00* | | | | |
| *John Jones* ......... | *20 00* | *7* | *20 00* | | | | |
| *B. C. Morris* ........ | *5 00* | *18* | *5 00* | | | | |
| | *35 00* | | *(72) 35 00* | | | | |

Fig. 95

In Figs. 96 and 97 are shown the ledger accounts of Allen, Jones, and Morris and the Creditors Controlling account after postings are made from the cash payments journal, shown in Fig. 95.

**Arthur Allen** Page 3

| | | | | | |
|---|---|---|---|---|---|
| | *CP1* | *10 00* | | *PJ1* | *10 00* |

**John Jones** Page 7

| | | | | | |
|---|---|---|---|---|---|
| | *CP1* | *20 00* | | *PJ1* | *40 00* |

**B. C. Morris** Page 18

| | | | | | |
|---|---|---|---|---|---|
| | *CP1* | *5 00* | | *PJ1* | *20 00* |

Fig. 96

**Creditors Control** Page 12

| | | | | | |
|---|---|---|---|---|---|
| | *CP1* | *35 00* | | *PJ1* | *70 00* |

Fig. 97

The credit balance in the Creditors Controlling account is now \$35.00, which is equal to the balance of \$20.00 in the account of John Jones, plus \$15.00 in the account of B. C. Morris, in the subordinate creditors ledger. This illustrates in a simple way the relationship which exists between the controlling account and the subordinate ledger.

It may be said at this point that the basic principles of accounting have now been covered. It is true, of course, that the application of these principles will indicate wide variations in practice and procedure. Nevertheless, that which is fundamental in accounting procedure has been covered. It therefore appears desirable at this point to present a fairly detailed illustration of these basic principles. This illustration will cover: (1) journalizing, (2) posting, (3) trial balance, (4) controlling accounts, (5) adjusting, closing, and post-closing entries, (6) work sheet, (7) preparation of statements.

In order to present the complete procedure for a concern for a period of one week there is reproduced in Fig. 98 the post-closing trial balance of James Morrison.

January 2. Sell on account to A. B. Grade \$59.00, terms 2/10, n/30. Purchase from Morrison Supply Company merchandise \$500.00 on account, terms 2/10, n/60. Pays for repairs \$15.00. Cash sales for day \$220.00.

## James Morrison

### Post-Closing Trial Balance

**as at December 31, 19—**

| | | |
|---|---|---|
| *Cash in Bank* | 650.00 | |
| *Cash on Hand* | 50.00 | |
| *Accounts Receivable* | 41,600.00 | |
| *Notes Receivable* | 200.00 | |
| *Land* | 4,000.00 | |
| *Buildings* | 75,000.00 | |
| *Furniture and Fixtures* | 5,000.00 | |
| *Delivery Equipment* | 2,000.00 | |
| *Reserve for Depreciation on Buildings* | | 14,500.00 |
| *Reserve for Depreciation on Furniture and Fixtures* | | 1,500.00 |
| *Reserve for Depreciation on Delivery Equipment* | | 1,100.00 |
| *Investments* | 2,400.00 | |
| *Prepaid Insurance* | 400.00 | |
| *Accounts Payable* | | 13,000.00 |
| *Notes Payable* | | 800.00 |
| *Mortgage on Buildings* | | 10,000.00 |
| *James Morrison, Net Worth* | | 161,945.67 |
| *Supplies* | 100.00 | |
| *Reserve for Bad Debts* | | 416.00 |
| *Interest Accrued* | | 233.33 |
| *Inventory, Dec. 31, 19—* | 73,000.00 | |
| *Wages Accrued* | | 790.00 |
| *Taxes Accrued* | | 115.00 |
| | 204,600.00 | 204,600.00 |

Fig. 98

January 3. Sell on account to E. D. Morton $16.00, terms 2/10, n/30 and to J. A. Gould $97.00, terms 2/10, n/30. Cash sales $247.00. A. B. Grade returns merchandise $5.00. Return to Morrison Supply Company merchandise $6.00.

January 4. Pays for advertising $30.00. Purchase furniture and fixtures for store $100.00 cash. Purchases delivery truck for $650.00 cash. Cash sales for day $225.00. A. B. Grade pays balance of his account taking 2% discount. E. D. Morton pays $5.00 on account.

January 5. Cash sales for the day $310.00. Sell on account to Moses Bloom $211.00, terms 2/10, n/30 and to K. B. West $115.00, terms 2/10, n/30. Pays wages $36.00.

January 6. Cash sales for day $311.00. Moses Bloom returns merchandise $12.00. Purchases merchandise $700.00 from Best Supply Company, terms 2/10, n/60.

January 7. Returns merchandise to Best Supply Company $32.00. Purchases supplies for store $47.00, cash. Cash sales for day $297.00. Sells to K. B. West on account $49.00 and to S. K. Smith merchandise $36.00. Pay Morrison Supply Company for goods purchased Jan. 2, less discount.

## James Morrison

### Working Paper

**Week Ended January 7, 19—**

| Account Title | Trial Balance Dr. | Trial Balance Cr. | Adjustments Dr. | Adjustments Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. | Profit and Loss Dr. | Profit and Loss Cr. | Balance Sheet Dr. | Balance Sheet Cr. |
|---|---|---|---|---|---|---|---|---|---|---|
| *Cash in Bank* | 955.80 | | | | 955.90 | | | | 955.90 | |
| *Cash on Hand* | 50.00 | | | | 50.00 | | | | 50.00 | |
| *Customers* | 42,107.00 | | | | 42,107.00 | | | | 42,107.00 | |
| *Notes Receivable* | 200.00 | | | | 200.00 | | | | 200.00 | |
| *Land* | 4,000.00 | | | | 4,000.00 | | | | 4,000.00 | |
| *Buildings* | 75,000.00 | | | | 75,000.00 | | | | 75,000.00 | |
| *Furniture and Fixtures* | 5,100.00 | | | | 5,100.00 | | | | 5,100.00 | |
| *Delivery Equipment* | 2,650.00 | | | | 2,650.00 | | | | 2,650.00 | |
| *Reserve for Depreciation on Buildings* | | 14,500.00 | | (3) 115.00 | | 14,615.00 | | | | 14,615.00 |
| *Reserve for Depreciation on Furniture and Fixtures* | | 1,500.00 | | (4) 10.00 | | 1,510.00 | | | | 1,510.00 |
| *Reserve for Depreciation on Delivery Equipment* | | 1,100.00 | | (5) 13.00 | | 1,113.00 | | | | 1,113.00 |
| *Investments* | 2,400.00 | | | | 2,400.00 | | | | 2,400.00 | |
| *Prepaid Insurance* | 400.00 | | | (6) 4.00 | 396.00 | | | | 396.00 | |
| *Creditors* | | 13,668.00 | | | | 13,668.00 | | | | 13,668.00 |
| *Notes Payable* | | 800.00 | | | | 800.00 | | | | 800.00 |
| *Mortgage on Buildings* | | 10,000.00 | | | | 10,000.00 | | | | 10,000.00 |
| *James Morrison, Net Worth* | | 161,945.67 | | | | 161,945.67 | | | | 161,945.67 |
| *Supplies* | 147.00 | | | (11) 10.00 | 137.00 | | | | 137.00 | |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Reserve for Bad Debts | | 416 00 | | (2) 8 00 | | 424 00 | | | | 424 00 |
| Interest Accrued | | 233 33 | | (7) 13 67 | | 247 00 | | | | 247 00 |
| Inventory, Jan. 1, 19— | 73,000 00 | | | (1)73,000 00 | | | | | | |
| Wages Accrued | | 790 00 | | (9) 200 00 | | 990 00 | | | | 990 00 |
| Taxes Accrued | | 115 00 | | (10) 10 00 | | 125 00 | | | | 125 00 |
| Purchases | 1,200 00 | | (1)73,000 00 | (8)72,900 00 | 1,300 00 | | 1,300 00 | | | |
| Purchase Returns | | 38 00 | | | | 38 00 | | 38 00 | | |
| Sales | | 2,193 00 | | | | 2,193 00 | | 2,193 00 | | |
| Sales Returns | 17 00 | | | | 17 00 | | 17 00 | | | |
| Discount on Sales | 1 08 | | | | 1 08 | | 1 08 | | | |
| Discount on Purchases | | 9 88 | | | | 9 88 | | 9 88 | | |
| Wages | 36 00 | | (9) 200 00 | | 236 00 | | 236 00 | | | |
| Advertising | 30 00 | | | | 30 00 | | 30 00 | | | |
| Repairs | 15 00 | | | | 15 00 | | 15 00 | | | |
| Bad Debts Expense | | | (2) 8 00 | | 8 00 | | 8 00 | | | |
| Depreciation Expense—Buildings | | | (3) 115 00 | | 115 00 | | 115 00 | | | |
| Depreciation Expense—Furniture and Fixtures | | | (4) 10 00 | | 10 00 | | 10 00 | | | |
| Depreciation Expense—Delivery Equipment | | | (5) 13 00 | | 13 00 | | 13 00 | | | |
| Insurance Expense | | | (6) 4 00 | | 4 00 | | 4 00 | | | |
| Interest Expense | | | (7) 13 67 | | 13 67 | | 13 67 | | | |
| Inventory, Jan. 7, 19— | | | (8)72,900 00 | | 72,900 00 | | | | 72,900 00 | |
| Taxes Expense | | | (10) 10 00 | | 10 00 | | 10 00 | | | |
| Supplies Expense | | | (11) 10 00 | | 10 00 | | 10 00 | | | |
| Net Profit for Week | | | | | | | 458 13 | | | 458 13 |
| | 207,308 88 | 207,308 88 | 146,283 67 | 146,283 67 | 207,678 65 | 207,678 55 | 2,240 88 | 2,240 88 | 205,895 90 | 205,895 80 |

In order to make the adjusting and closing entries as at January 7 and prepare a balance sheet as in Fig. 99, and a profit and loss statement as in Fig. 100, the following information is given.

1. Depreciation should be allowed as follows:
   a) Buildings $115.00
   b) Furniture and Fixtures $10.00
   c) Delivery Equipment $13.00
2. Insurance expired for the week amounts to $4.00.
3. $8.00 should be added to the reserve for bad debts.
4. Supplies consumed during the week amount to $10.00.
5. Interest accrued on mortgage for the week amounts to $13.67.
6. The inventory on January 7 amounts to $72,900.00.
7. Wages accrued for the week amount to $200.00.
8. Taxes accrued for the week are estimated at $10.00.

**Purchase Journal** Page 1

| | | | | | |
|---|---|---|---|---|---|
| *Jan.* | *2* | *Morrison Supply Co.* | *2/10, n/30* | *2* | *500.00* |
| | *6* | *Best Supply Co.* | *2/10, n/60* | *3* | *700.00* |
| | *7* | *Creditors, Cr.* | | *GL14* | |
| | *7* | *Purchases, Dr.* | | *GL21* | *1,200.00* |

**Purchase Returns Journal** Page 1

| | | | | | |
|---|---|---|---|---|---|
| *Jan.* | *3* | *Morrison Supply Co.* | | *2* | *6.00* |
| | *7* | *Best Supply Co.* | | *3* | *32.00* |
| | *7* | *Creditors, Dr.* | | *GL14* | |
| | *7* | *Purchase Returns, Cr.* | | *GL25* | *38.00* |

**Sales Journal** Page 1

| | | | | | |
|---|---|---|---|---|---|
| *Jan.* | *2* | *A. B. Grade* | *2/10, n/30* | *2* | *59.00* |
| | *3* | *E. D. Morton* | *2/10, n/30* | *3* | *76.00* |
| | *3* | *J. A. Gould* | *2/10, n/30* | *4* | *97.00* |
| | *5* | *Moses Bloom* | *2/10, n/30* | *5* | *211.00* |
| | *5* | *K. B. West* | *2/10, n/30* | *6* | *115.00* |
| | *7* | *K. B. West* | *2/10, n/30* | *6* | *49.00* |
| | *7* | *S. K. Smith* | *2/10, n/30* | *7* | *36.00* |
| | *7* | *Customers, Dr.* | | *GL 3* | |
| | *7* | *Sales, Cr.* | | *GL26* | *583.00* |

**Sales Returns Journal** Page 1

| | | | | | |
|---|---|---|---|---|---|
| *Jan.* | *3* | *A. B. Grade* | | *2* | *5.00* |
| | *6* | *Moses Bloom* | | *5* | *12.00* |
| | *7* | *Customers, Cr.* | | *GL 3* | |
| | *7* | *Sales Returns, Dr.* | | *GL27* | *17.00* |

**Cash Receipts Journal** 1

| Date | | Explanation | Bank, Dr. | Cash Sales, Cr. | A.R. L.F. | Customers, Cr. | Discount on Sales, Dr. | G.L. F. | Sundries, Cr. |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | 2 | *Sales* | 220 00 | 220 00 | | | | | |
| | 3 | *Sales* | 247 00 | 247 00 | | | | | |
| | 4 | *Sales* | 225 00 | 225 00 | | | | | |
| | 4 | *A. B. Grade* | 52 92 | | 2 | 54 00 | 1 08 | | |
| | 4 | *E. D. Morton* | 5 00 | | 3 | 5 00 | | | |
| | 5 | *Sales* | 310 00 | 310 00 | | | | | |
| | 6 | *Sales* | 311 00 | 311 00 | | | | | |
| | 7 | *Sales* | 297 00 | 297 00 | | | | | |
| | | | (1) 1,667 92 | (26) 1,610 00 | | (3) 59 00 | (28) 1 08 | | |

**Cash Payments Journal** 1

| Date | | Explanation | Bank, Cr. | A.P. L. F. | Creditors, Dr. | Discount Purchases, Cr. | Wages, Dr. | Advertising, Dr. | G.L. F. | Sundries, Dr. |
|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | | |
| *Jan.* | 2 | *Repairs* | 15 00 | | | | | | 32 | 15 00 |
| | 4 | *Advertising* | 30 00 | | | | | 30 00 | | |
| | 4 | *Furniture and Fixtures* | 100 00 | | | | | | 7 | 100 00 |
| | 4 | *Delivery Truck* | 650 00 | | | | | | 8 | 650 00 |
| | 5 | *Wages* | 36 00 | | | | 36 00 | | | |
| | 7 | *Supplies* | 47 00 | | | | | | 18 | 47 00 |
| | 7 | *Morrison Supply Co* | 484 12 | 2 | 494 00 | 9 88 | | | | |
| | | | (1) 1,362 12 | | (14) 494 00 | (29) 9 88 | (30) 36 00 | (31) 30 00 | | 812 00 |

**General Journal**

| | | | | | |
|---|---|---|---|---|---|
| | | Adjusting Entries | | | |
| *Jan.* | 7 | *Purchases* | 24 | 73,000 00 | |
| | | *Inventory, Jan. 1, 19—* | 21 | | 73,000 00 |
| | | *To carry opening inventory to Purchase account.* | | | |
| | 7 | *Bad Debts Expense* | 34 | 8 00 | |
| | | *Reserve for Bad Debts* | 19 | | 8 00 |
| | | *Estimated allowance for Bad Debts.* | | | |
| | 7 | *Depreciation Expense—Buildings* | 35 | 115 00 | |
| | | *Reserve for Depreciation on Buildings* | 9 | | 115 00 |
| | | *Estimated depreciation for one week.* | | | |
| | 7 | *Depreciation Expense on Furniture and Fixtures* | 36 | 10 00 | |
| | | *Reserve for Depreciation on Furniture and Fixtures* | 10 | | 10 00 |
| | | *Estimated depreciation for one week.* | | | |
| | 7 | *Depreciation Expense—Delivery Equipment* | 37 | 13 00 | |
| | | *Reserve for Depreciation on Delivery Equipment* | 11 | | 13 00 |
| | | *Estimated depreciation for one week.* | | | |
| | 7 | *Depreciation Expense—Insurance* | 38 | 4 00 | |
| | | *Prepaid Insurance* | 13 | | 4 00 |
| | | *Estimated depreciation for one week.* | | | |
| | 7 | *Interest Expense* | 39 | 13 67 | |
| | | *Interest Accrued* | 20 | | 13 67 |
| | | *Interest accrued for one week.* | | | |
| | 7 | *Inventory, January 7, 19—* | 21 | 72,900 00 | |
| | | *Purchases* | 24 | | 72,900 00 |
| | | *To credit Inventory to Purchases account.* | | | |
| | 7 | *Wages* | 30 | 200 00 | |
| | | *Wages Accrued* | 22 | | 200 00 |
| | | *Wages accrued for one week.* | | | |
| | 7 | *Taxes Expense* | 41 | 10 00 | |
| | | *Taxes Accrued* | 23 | | 10 00 |
| | | *Taxes accrued for one week.* | | | |
| | 7 | *Supplies Expense* | 42 | 10 00 | |
| | | *Supplies* | 18 | | 10 00 |
| | | *Supplies consumed for one week.* | | | |
| | | Closing Entries | | | |
| | 7 | *Profit and Loss* | 33 | 1,782 75 | |
| | | *Purchases* | 24 | | 1,300 00 |
| | | *Sales Returns* | 27 | | 17 00 |
| | | *Discount on Sales* | 28 | | 1 08 |
| | | *Wages* | 30 | | 236 00 |
| | | *Advertising* | 31 | | 30 00 |
| | | *Repairs* | 32 | | 15 00 |
| | | *Bad Debts Expense* | 34 | | 8 00 |
| | | *Depreciation Expense—Buildings* | 35 | | 115 00 |
| | | *Depreciation Expense—Furniture and Fixtures* | 36 | | 10 00 |
| | | *Depreciation Expense—Delivery Equipment* | 37 | | 13 00 |
| | | *Depreciation Expense—Insurance* | 38 | | 4 00 |
| | | *Interest Expense* | 39 | | 13 67 |
| | | *Taxes Expense* | 41 | | 10 00 |
| | | *Supplies Expense* | 42 | | 10 00 |
| | | *To Close.* | | | |

**General Journal**—*Continued*

| | | | | |
|---|---|---|---|---|
| 7 | *Purchase Returns* | 25 | 38 00 | |
| | *Sales* | 26 | 2,193 00 | |
| | *Discount on Purchase* | 29 | 9 88 | |
| | *Profit and Loss* | 33 | | 2,240 88 |
| | *To Close.* | | | |
| 7 | *Profit and Loss* | 33 | 458 13 | |
| | *James Morrison, Net Worth* | 17 | | 458 13 |
| | *To Close.* | | | |

## General Ledger

1

### Cash in Bank

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | 7 | *Balance* | | 650 00 | *Jan.* | 7 | *Sundries* | *CP1* | 1,362 12 |
| | 7 | *Sales* | *CR1* | 1,667 92 | | | | | |
| | | *955.80* | | | | | | | |

2

### Cash on Hand

| | | | | |
|---|---|---|---|---|
| 19— | | | | |
| *Jan.* | 7 | *Balance* | | 50 00 |

3

### Customers

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | 7 | *Balance* | | 41,600 00 | *Jan.* | 7 | *Sales Returns* | *SRJ1* | 17 00 |
| | 7 | *Sales* | *SJ1* | 583 00 | | 7 | *Cash* | *CR1* | 59 00 |
| | | *42,107.00* | | | | | | | |

4

### Notes Receivable

| | | | | |
|---|---|---|---|---|
| 19— | | | | |
| *Jan.* | 7 | *Balance* | | 200 00 |
| | | *200.00* | | |

5

### Land

| | | | | |
|---|---|---|---|---|
| 19— | | | | |
| *Jan.* | 7 | *Balance* | | 4,000 00 |
| | | *4,000.00* | | |

6

### Buildings

| | | | | |
|---|---|---|---|---|
| 19— | | | | |
| *Jan.* | 7 | *Balance* | | 75,000 00 |
| | | *75,000.00* | | |

**General Ledger**—*Continued*

7

Furniture and Fixtures

| 19— | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Balance* | | *5,000.00* | | | | | |
| | *4* | *Cash* | *CP1* | *100.00* | | | | | |
| | | *5,100.00* | | | | | | | |

8

Delivery Equipment

| 19— | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Balance* | | *2,000.00* | | | | | |
| | *4* | *Cash* | *CP1* | *650.00* | | | | | |
| | | *2,650.00* | | | | | | | |

9

Reserve for Depreciation on Buildings

| | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | *Jan.* | *1* | *Balance* | | *14,500.00* |
| | | | | | | *7* | *Depreciation Expense—Buildings* | *GJ1* | *115.00* |
| | | | | | | | *14,615.00* | | |

10

Reserve for Depreciation on Furniture and Fixtures

| | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | *Jan.* | *1* | *Balance* | | *1,500.00* |
| | | | | | | *7* | *Depreciation Expense—Furniture and Fixtures* | *GJ1* | *10.00* |
| | | | | | | | *1,510.00* | | |

11

Reserve for Depreciation on Delivery Equipment

| | | | | | 19— | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | *Jan.* | *1* | *Balance* | | *1,100.00* |
| | | | | | | *7* | *Depreciation Expense—Delivery Equipment* | *GJ1* | *13.00* |
| | | | | | | | *1,113.00* | | |

12

Investments

| 19— | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Jan.* | *1* | *Balance* | | *2,400.00* | | | | | |
| | | *2,400.00* | | | | | | | |

**General Ledger**—*Continued*

13

### Prepaid Insurance

| Date | | Explanation | Ref. | Amount | Date | | Explanation | Ref. | Amount |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *7* | *Balance* ....... | | *400 00* | *Jan.* | *7* | *Depreciation Expense — Insurance* ........ | *GJ1* | *4 00* |
| | | *396.00* | | | | | | | |

14

### Creditors

| Date | | Explanation | Ref. | Amount | Date | | Explanation | Ref. | Amount |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *7* | *Purchase Returns* | *PRJ1* | *38 00* | *Jan.* | *1* | *Balance* ..... | | *13,000 00* |
| | *7* | *Cash* ......... | *CP1* | *494 00* | | *7* | *Purchases* ... | *PJ1* | *1,200 00* |
| | | | | | | | *13,668.00* | | |

15

### Notes Payable

| Date | | Explanation | Ref. | Amount | Date | | Explanation | Ref. | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* ....... | | *800 00* |
| | | | | | | | *800.00* | | |

16

### Mortgage on Building

| Date | | Explanation | Ref. | Amount | Date | | Explanation | Ref. | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* ....... | | *10,000 00* |
| | | | | | | | *10,000.00* | | |

17

### James Morrison, Net Worth

| Date | | Explanation | Ref. | Amount | Date | | Explanation | Ref. | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* ....... | | *161,945 67* |
| | | | | | | *7* | *Profit and Loss* .. | *GJ2* | *458 13* |
| | | | | | | | *162,403.80* | | |

18

### Supplies

| Date | | Explanation | Ref. | Amount | Date | | Explanation | Ref. | Amount |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *1* | *Balance* ....... | | *100 00* | *Jan.* | *7* | *Supplies Expense* | *GJ2* | *10 00* |
| | *7* | *Cash* ......... | *CP1* | *47 00* | | | | | |
| | | *137.00* | | | | | | | |

**General Ledger**—*Continued*

19

### Reserve for Bad Debts

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* . . . . | | *416 00* |
| | | | | | | *7* | *Bad Debts Expense* . | *GJ1* | *8 00* |
| | | | | | | | *424.00* | | |

20

### Interest Accrued

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* . | | *233 33* |
| | | | | | | *7* | *Interest Expense* | *GJ1* | *13 67* |
| | | | | | | | *247.00* | | |

21

### Inventory

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *1* | *Balance* . . . | | *73,000 00* | *Jan.* | *7* | *Purchases* . . . | *GJ1* | *73,000 00* |
| | *7* | *Purchases* . | *GJ1* | *72,900 00* | | | | | |
| | | *72,900.00* | | | | | | | |

22

### Wages Accrued

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* | | *790 00* |
| | | | | | | *7* | *Wages* | *GJ1* | *200 00* |
| | | | | | | | *990.00* | | |

23

### Taxes Accrued

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 19— | | | | |
| | | | | | *Jan.* | *1* | *Balance* . . . . | *GJ1* | *115 00* |
| | | | | | | *7* | *Taxes Expense* | *GJ2* | *10 00* |
| | | | | | | | *125.00* | | |

24

### Purchases

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *7* | *Creditors* . . . . . . | *PJ1* | *1,200 00* | *Jan.* | *7* | *Inventory* . . . . . . | *GJ1* | *72,900 00* |
| | *7* | *Inventory* . . . . . . | *GJ1* | *73,000 00* | | *7* | *Profit and Loss* . | *GJ2* | *1,300 00* |
| | | | | *74,200 00* | | | | | *74,200 00* |

**General Ledger**—*Continued*

25

Purchase Returns

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Profit and Loss* | *GJ2* | 38 | 00 | *Jan.* | 7 | *Creditors . . .* | *PRJ1* | 38 | 00 |

26

Sales

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Profit and Loss* | *GJ2* | 2,193 | 00 | *Jan.* | 7 | *Customers .* | *SJ1* | 583 | 00 |
| | | | | | | | 7 | *Cash . . .* | *CR1* | 1,610 | 00 |
| | | | | 2,193 | 00 | | | | | 2,193 | 00 |

27

Sales Returns

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Sales Returns.* | *SRJ1* | 17 | 00 | *Jan.* | 7 | *Profit and Loss* | *GJ2* | 17 | 00 |

28

Discount on Sales

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Sales . . . . . . .* | *CR1* | 1 | 08 | *Jan.* | 7 | *Profit and Loss.* | *GJ2* | 1 | 08 |

29

Discount on Purchases

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Profit and Loss.* | *GJ2* | 9 | 88 | *Jan.* | 7 | *Creditors . . .* | *CP1* | 9 | 88 |

30

Wages

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 5 | *Cash . . . . . . .* | *CP1* | 36 | 00 | *Jan.* | 7 | *Profit and Loss. .* | *GJ2* | 236 | 00 |
| | 7 | *Wages Accrued.* | *GJ1* | 200 | 00 | | | | | | |
| | | | | 236 | 00 | | | | | 236 | 00 |

31

Advertising

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Cash . . . . . . . . .* | *CP1* | 30 | 00 | *Jan.* | 7 | *Profit and Loss.* | *GJ2* | 30 | 00 |

**General Ledger**—*Continued*

32

Repairs

| Date | | Item | Fo. | Amount | | Date | | Item | Fo. | Amount |
|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | |
| Jan. | 2 | Cash | CP1 | 15 | 00 | Jan. | 7 | Profit and Loss | GJ2 | 15 | 00 |

33

Profit and Loss

| Date | | Item | Fo. | Amount | | Date | | Item | Fo. | Amount | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| Jan. | 7 | Sundries | GJ2 | 1,782 | 75 | Jan. | 7 | Sundries | GJ2 | 2,240 | 88 |
| | 7 | J. Morrison, N. W. | GJ2 | 458 | 13 | | | | | | |
| | | | | 2,240 | 88 | | | | | 2,240 | 88 |

34

Bad Debts Expense

| Date | | Item | Fo. | Amount | | Date | | Item | Fo. | Amount | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| Jan. | 7 | Reserve for Bad Debts | GJ1 | 8 | 00 | Jan. | 7 | Profit and Loss | GJ2 | 8 | 00 |

35

Depreciation Expense—Buildings

| Date | | Item | Fo. | Amount | | Date | | Item | Fo. | Amount | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| Jan. | 7 | Reserve Depreciation—Buildings | GJ1 | 115 | 00 | Jan. | 7 | Profit and Loss | GJ2 | 115 | 00 |

36

Depreciation Expense—Furniture and Fixtures

| Date | | Item | Fo. | Amount | | Date | | Item | Fo. | Amount | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| Jan. | 7 | Reserve Depreciation—Furniture and Fixtures | GJ1 | 10 | 00 | Jan. | 7 | Profit and Loss | GJ2 | 10 | 00 |

37

Depreciation Expense—Delivery Equipment

| Date | | Item | Fo. | Amount | | Date | | Item | Fo. | Amount | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| Jan. | 7 | Reserve Depreciation—Delivery Equipment | GJ1 | 13 | 00 | Jan. | 7 | Profit and Loss | GJ2 | 13 | 00 |

**General Ledger**—*Continued* 38

Depreciation Expense—Insurance

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Prepaid Insurance* | GJ1 | 4 | 00 | *Jan.* | 7 | *Profit and Loss* | GJ2 | 4 | 00 |

39

Interest Expense

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Interest Accrued.* | GJ1 | 13 | 67 | *Jan.* | 7 | *Profit and Loss* | GJ2 | 13 | 67 |

40

Taxes Expense

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Taxes Accrued* | GJ2 | 10 | 00 | *Jan.* | 7 | *Profit and Loss.* | GJ2 | 10 | 00 |

41

Supplies Expense

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 7 | *Supplies. . . .* | GJ2 | 10 | 00 | *Jan.* | 7 | *Profit and Loss. .* | GJ2 | 10 | 00 |

**Accounts Payable Ledger** 1

Old Accounts
(not shown in detail)

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 19— | | | | | |
| | | | | | | *Jan.* | 1 | *13,000.00* | | 13,000 | 00 |

2

Morrison Supply Company

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | 19— | | | | | |
| *Jan.* | 3 | *Purchase Returns* | PRJ1 | 6 | 00 | *Jan.* | 2 | *Purchases. . . . . .* | PJ1 | 500 | 00 |
| | 7 | *Cash. . . . . . . .* | CP1 | 494 | 00 | | | | | | |

**Creditors' Ledger**—*Continued*

3

Best Supply Company

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *7* | *Purchase Returns* | *PRJ1* | *32.00* | *Jan.* | *7* | *Purchases* ..... *668.00* | *PJ1* | *700.00* |

**Accounts Receivable Ledger**

1

Old Accounts
(not shown in detail)

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | *1* | *Balance.* .... *41,600.00* | | *41,600.00* | | | | | |

2

A. B. Grade

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *2* | *Sales*......... | *SJ1* | *59.00* | *Jan.* | *3* | *Sales Returns* .. | *SRJ1* | *5.00* |
| | | | | | | *4* | *Cash*......... | *CRJ1* | *54.00* |

3

E. D. Morton

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *3* | *Sales*.... ... *11.00* | *SJ1* | *16.00* | *Jan.* | *4* | *Cash*......... | *CRJ1* | *5.00* |

4

J. A. Gould

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | *3* | *Sales*......... *97.00* | *SJ1* | *97.00* | | | | | |

5

Moses Bloom

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | 19— | | | | |
| *Jan.* | *5* | *Sales*......... *199.00* | *SJ1* | *211.00* | *Jan.* | *6* | *Sales Returns*... | *SRJ1* | *12.00* |

6

K. B. West

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | *5* | *Sales*.... .... | *SJ1* | *115.00* | | | | | |
| | *7* | *Sales*......... *164.00* | *SJ1* | *49.00* | | | | | |

7

S. K. Smith

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 19— | | | | | | | | | |
| *Jan.* | *7* | *Sales*......... *36.00* | *SJ1* | *36.00* | | | | | |

**James Morrison**

BALANCE SHEET

**as at January 7, 19—**

| | | | |
|---|---|---|---|
| Current Assets: | | | |
| Cash in Bank | | $ 955.80 | |
| Cash on Hand | | 50.00 | |
| Inventory, Jan. 7, 19— | | 72,900.00 | |
| Customers | $42,107.00 | | |
| Less Reserve for Bad Debts | 424.00 | 41,683.00 | |
| Notes Receivable | | 200.00 | |
| Supplies | | 137.00 | $115,925.80 |
| Fixed Assets: | | | |
| Land | | $4,000.00 | |
| Buildings | $75,000.00 | | |
| Less Reserve for Depreciation | 14,615.00 | 60,385.00 | |
| Furniture and Fixtures | $ 5,100.00 | | |
| Less Reserve for Depreciation | 1,510.00 | 3,590.00 | |
| Delivery Equipment | $ 2,650.00 | | |
| Less Reserve for Depreciation | 1,113.00 | 1,537.00 | 69,512.00 |
| Investments | | | 2,400.00 |
| Deferred Assets: | | | |
| Prepaid Insurance | | | 396.00 |
| | | | $188,233.80 |

| | | |
|---|---|---|
| Current Liabilities: | | |
| Creditors | $ 13,668.00 | |
| Notes Payable | 800.00 | |
| Interest Accrued | 247.00 | |
| Wages Accrued | 990.00 | |
| Taxes Accrued | 125.00 | $ 15,830.00 |
| Fixed Liability: | | |
| Mortgage | | 10,000.00 |
| Net Worth: | | |
| James Morrison, Capital | $161,945.67 | |
| Add Net Profit Jan. 1–7 | 458.13 | 162,403.80 |
| | | $188,233.80 |

Fig. 99

## James Morrison

### Profit and Loss Statement

**Week Ended January 7, 19—**

| | | | |
|---|---|---|---|
| *Sales* | | | 2,193.00 |
| *Less Returns* | | | 17.00 |
| *Net Sales* | | | 2,176.00 |
| *Less Cost of Goods Sold:* | | | |
| *Inventory, Jan. 1, 19—* | | 73,000.00 | |
| *Purchases (net)* | | 1,162.00 | |
| | | 74,162.00 | |
| *Inventory, Jan. 7, 19—* | | 72,900.00 | 1,262.00 |
| *Gross Profit* | | | 914.00 |
| *Deduct Operating Expenses:* | | | |
| *Selling:* | | | |
| *Discount on Sales* | 1.08 | | |
| *Advertising* | 30.00 | | |
| *Wages* | 236.00 | 267.08 | |
| *Administrative:* | | | |
| *Repairs* | 15.00 | | |
| *Depreciation—Buildings* | 115.00 | | |
| *Depreciation—Furniture and Fixtures* | 10.00 | | |
| *Depreciation—Delivery Equipment* | 13.00 | | |
| *Insurance* | 4.00 | | |
| *Bad Debts* | 8.00 | | |
| *Taxes* | 10.00 | | |
| *Supplies* | 10.00 | 185.00 | |
| *Financial:* | | | |
| *Interest Expense* | 13.67 | | |
| *Less Discounts on Purchases* | 9.88 | 3.79 | 455.87 |
| *Net Profit for Week* | | | 458.13 |

Fig. 100

## *Chapter* 10

# BUSINESS PROCEDURE AND BUSINESS PAPERS

**Business Organization.** The development of industrialism has made it desirable to establish business enterprises of considerable size. The work done by such enterprises may make it necessary to employ hundreds or even thousands of men and women. Where a business unit is of such size, it is obvious that chaos and failure would result were all activities not coordinated and all employees made definitely responsible.

In case of the modern corporation, the owners are known as stockholders, their ownership being signified by the number of shares of stock which each holds in the corporation. Since the number of stockholders is frequently large and since also stockholders usually have other interests, it becomes necessary for the stockholders to elect a board of directors to which they delegate the responsibility for the management of the corporation. The status of stockholders and directors has received much attention on the part of courts and legislators, so that at the present time it may be said that it is well outlined from the legal point of view. In other words, one seeking light on the legal principles which govern the relation of stockholders to the board of directors and on the general status of stockholders and directors will find an abundance of information in the various treatises and encylopedias on corporation law.

The board of directors is a small body, composed usually of not more than fifteen persons. It is presided over by the president of the corporation. It meets annually and at other times as conditions warrant. It is unfortunate, in American corporation practice, that boards of directors have sometimes been composed of mere figureheads who have taken little or no real interest in the affairs of the corporation. Directors should be chosen for their special capacities to serve a corporation. For instance, one director might be a corpo-

ration lawyer, another an accountant, etc. As the demand for skilled directors increases, it may be expected that more attention will be given to the qualifications of directors.

No organization can succeed whose structure is not based on the fundamental principle of undivided responsibility. No person, however capable, can carry on satisfactorily unless he knows to whom he is responsible, and it is obvious that he cannot be responsible equally to two or more persons. It is for this reason that a corporation elects one president, not two or three. The man in charge of production then becomes fully responsible to the president and the same is true of those officers who have charge of other important functions, such as marketing, controlling, financing, and personnel.

The purpose of organization is to secure control of the various functions which a business performs. These functions vary according to the nature of the enterprise. Nevertheless, it will be found that most enterprises, when functions are analyzed, carry on activities more or less similar in character. To illustrate this fact, a chart in which the activities of corporate organization are presented in graphic form is shown in Fig. 101. Of course, this chart will require some modification to meet the requirements of particular concerns, but it will be found, nevertheless, that so far as fundamental processes are concerned it is fairly illustrative of modern business procedure. At the top of the organization are the stockholders, who in turn elect the board of directors, who in turn elect the president. This basic plan of organization is common to all organizations. Responsible to the president are the heads of the main operating divisions, such as production, marketing, controlling, financing, and personnel. The student should study the chart carefully with respect to the light it throws on the controlling function. It will be noted that controlling is subdivided into four primary activities, namely: (1) auditing, (2) budgets, (3) accounting, (4) statistics.

(1) Auditing is the analytical work connected with control. (2) Budgeting is essentially forecasting in character. (3) Accounting is the recording activity. (4) Statistical work is carried on with a view to the interpretation of greater masses of data, much of which is derived from the accounting records.

The greater detail shown in connection with the accounting

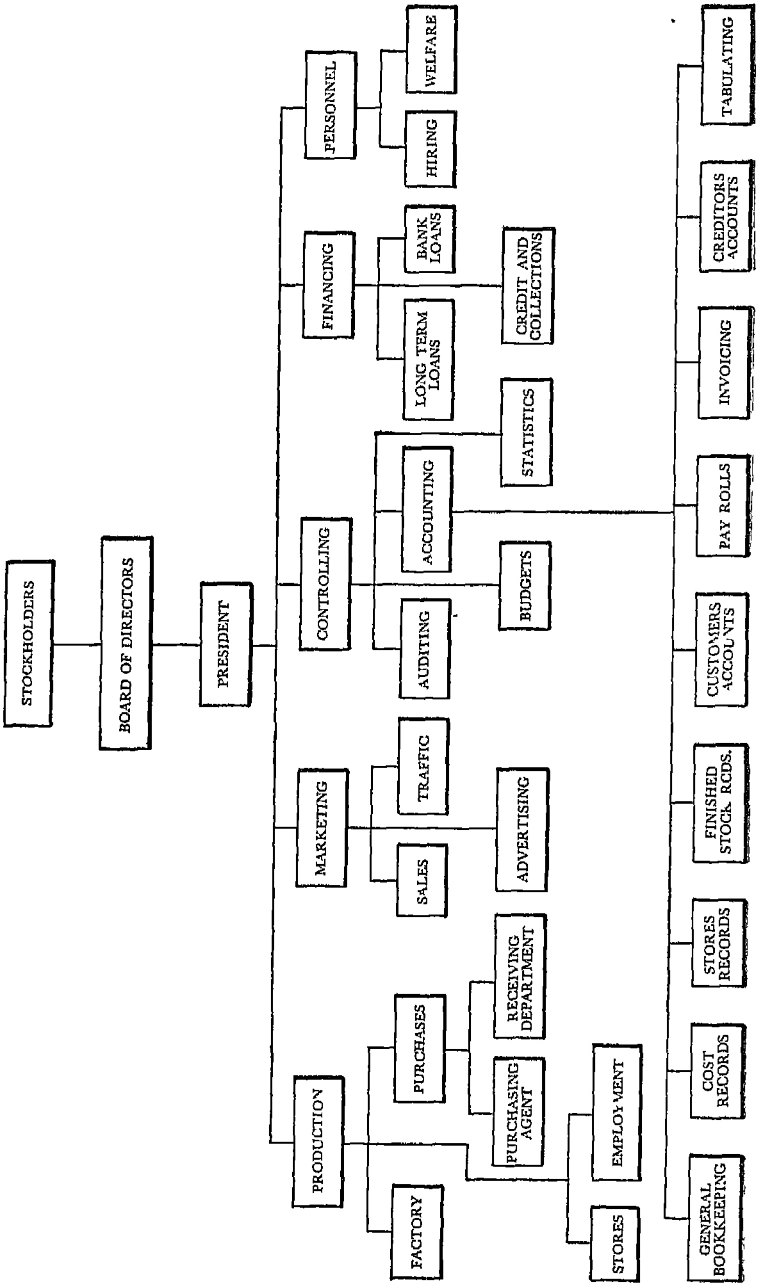

STOCKHOLDERS
BOARD OF DIRECTORS
PRESIDENT
PERSONNEL
WELFARE
HIRING
FINANCING
BANK LOANS
LONG TERM LOANS
CREDIT AND COLLECTIONS
CONTROLLING
STATISTICS
ACCOUNTING
BUDGETS
AUDITING
MARKETING
TRAFFIC
ADVERTISING
SALES
PRODUCTION
PURCHASES
RECEIVING DEPARTMENT
PURCHASING AGENT
EMPLOYMENT
FACTORY
STORES
TABULATING
CREDITORS ACCOUNTS
INVOICING
PAY ROLLS
CUSTOMERS ACCOUNTS
FINISHED STOCK RCDS.
STORES RECORDS
COST RECORDS
GENERAL BOOKKEEPING

Fig. 101

function is desirable because this book deals with the accounting function. The other functions might be elaborated but this seems unnecessary for present purposes. Thus under personnel, welfare might be further analyzed, and under marketing advertising might be elaborated.

The controlling function is not always given a position coordinate with production, marketing, financing, and personnel. It is sometimes subordinated to the financing function, in which event the man in charge of the controlling function is not usually an officer but is an employee responsible to the officer in charge of financing. The tendency, however, is to place greater emphasis on the controlling function because of the great recognition being given currently to accounting as a tool of management.

The student has learned enough about statements to realize that the controlling function cannot be exercised effectively unless the accounting records are so kept as to make possible the preparation of the necessary statements. Detailed records of customers' and creditors' accounts as well as detailed records of inventories, where these are necessary, must be so controlled that trial balances of the general ledger may be secured promptly and the necessary adjustments made to permit the timely preparation of balance sheets and profit and loss statements. Of course, as a concern's activities widen, it becomes necessary to supplement these fundamental statements with various statistical tabulations, which reflect light on such matters as expense distribution, costs as related to various activities, etc. These more or less specialized statements naturally must conform to the peculiarities and special requirements of the concern in question. They usually are prepared to meet such questions as arise in the mind of the manager in his attempt to carry on operations efficiently.

Although this is not a book treating of the science of management and control, the student should have some knowledge of the various fundamental functions or activities which are characteristic of most types of business; therefore in the following pages attention will be given to the five basic features emphasized in the chart shown in Fig. 101, namely: (1) production, (2) marketing, (3) controlling, (4) financing, (5) personnel.

**PRODUCTION**

**Purchasing.** Purchasing may be regarded as the first step in production. Here production is used in a broad sense to include the creation of commodities and services of all types. In a more restricted sense production refers to manufacturing.

Purchasing is performed by an expert, usually known as a purchasing agent. Of course, in a small concern the function of the purchasing agent may be performed by the owner. The purchasing agent must be expert in the work of locating the most economical source of raw materials, merchandise, and supplies of all kinds. If the purchasing agent has properly specialized in his work, he should be able to effect great savings by selecting the materials best suited to the purpose and by purchasing from those able to submit the lowest bids. The purchasing agent should know when to buy in advance of current requirements, and in order to do this effectively he should make a special study of price trends. Carefully systematized in his files should be found catalogues, price lists, special bargains, and other data readily available for his purposes.

The work of the purchasing agent must be coordinated with that of the various departments which send to him their requests for purchases and for which he in turn issues his purchase orders. The work of the purchasing agent must be coordinated in particular with the production and selling divisions of the enterprise. Raw materials and merchandise can be purchased intelligently only when information is forthcoming relative to the requirements of the production and selling divisions. Unless this is done there are likely to accumulate unnecessarily large quantities in the inventories of raw materials in the case of manufacturers and in the inventories of merchandise in the case of retail establishments.

In connection with purchasing, it is necessary to consider certain papers which have become more or less standardized in modern business. These are as follows: (1) the purchase requisition, (2) the purchase order, (3) the invoice.

1. *The Purchase Requisition.* The purchase requisition is the request that a purchase be made and it is sent to the purchasing agent by the department head or the general manager. In the

purchase requisition, the person issuing it indicates what materials or supplies are desired, when these will be required, and the exact amount of each article. If the requisition is issued by the department head, it should be approved by the general manager. If it is customary to purchase the materials in question from a given vendor, the person filling out the purchase requisition should indicate therein the vendor's name; otherwise this should be left blank to be filled in by the purchasing agent after he has determined where he will make the purchase. The purchase requisition should be made out in duplicate, one copy going to the purchasing agent and one being retained by the department head who issues the requisition. A form of purchase requisition is shown in Fig. 102.

2. *The Purchase Order.* Upon receipt of the purchase requisition, the purchasing agent takes the steps necessary to accomplish the purchase of the materials requisitioned. For this purpose he fills out a blank form known as a purchase order. This may be a more or less specialized form, depending upon circumstances. Sometimes, however, no particular form of purchase order is used, the order being given by letter, by telegram, or even by telephone. Oral orders should be avoided wherever possible because of the likelihood of misinterpretation and because of the lack of adequate record. As many copies of the purchase order should be made out as circumstances require. The original copy is mailed to the vendor, and one copy is retained in the files of the purchasing agent. One or more additional copies of the order may be necessary, depending upon the organization of the work. See Fig. 103.

3. *The Invoice.* When the vendor receives the purchase order issued by the vendee's purchasing agent, he proceeds to ship the goods, either in accordance with the vendee's specifications or in accordance with what is customary. The vendor also prepares an invoice, the original copy of which he sends to the vendee. A copy of the invoice is retained in the vendor's files. The invoice lists the items shipped, states unit price of each, and extends the amount of each kind of merchandise shipped. The total amount of the shipment is shown at the bottom of the invoice. The terms of a sale, which may be of much importance, should be indicated clearly in the invoice. A form of invoice is shown in Fig. 104.

**PURCHASE REQUISITION**

Requisition No.____________
Purchase Order No ____________
Account No.____________
Date____________

Vendor____________
Vendor's Address____________

| Description | Quantity |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |
| | |

Requisitioned by ____________

Approved by ____________

Fig. 102

**PURCHASE ORDER**

Purchase Order No __________
Requisition No. __________
Account No __________
Date __________

Vendor __________
Vendor's Address __________

Please furnish us with the materials specified below, in accordance with terms and prices indicated.

Date Required __________ Terms __________ How to Ship __________

| Description | Unit Price | Quantity | Amount |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

Signed __________ (Name of Vendee)

By __________ Purchasing Agent

Fig 103

**INVOICE**

Boston Wholesale Company
205 State Street
Chicago, Illinois

To________________________
(Name of Vendee)

Address________________________

Terms________________________

Date____________

No. of Invoice____________

Date Goods Shipped____________

How Shipped____________

| | | Description | Price Per Unit | Amount |
|---|---|---|---|---|
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | Total | | |

Fig 104

When the vendee receives the invoice, he should follow a routine procedure established in connection with the handling of all invoices. The time of receipt should be stamped on the invoice. This is usually done by means of a time clock. Sometimes invoices are received before the goods are received. If an invoice is received from a vendor from whom purchases are rarely made, it should be held until the goods are received before being placed in the routine procedure for payment. If, however, an invoice is received from a vendor from whom purchases are made frequently, it may not be necessary to wait until the goods are received. In the event that an adjustment becomes necessary, it may be made in connection with a succeeding payment.

Some concerns make it a policy to take all cash discounts; others may be unable to do this because of lack of working capital. In any event, procedure in handling invoices should be such that the essential facts relative to cash discounts are called to the attention of the proper party.

As a first step in the treatment of invoices, they should be sent to the purchasing agent in order that the description of the items thereon may be compared with the items shown on the duplicate copy of the purchase order. As a next step, it may be desirable to check the invoice against the goods when these are received. If, however, it is thought to be desirable not to permit the clerk who checks the goods to see the invoices, he may be required to submit a separate report which then can be compared with the invoice. This plan requires him to exercise greater care in describing and accounting for the merchandise in question.

When the invoice, properly checked as to goods received, is turned over to the accounting department, procedure varies according to the manner in which accounts with creditors are kept. If a voucher system (to be explained later) is in effect, a definite routine will be followed. If a voucher system is not in use, the procedure may vary somewhat, but it is likely that the invoices will be kept in a tickler and no entry made on the books until a check is issued in payment.

The forms shown above are those used in connection with purchasing of raw materials or merchandise. When a concern is

engaged in manufacturing, there may be specialized forms employed in connection with the requisitioning of materials from storeroom to factory and also in connection with the manufacturing process itself. These, however, are of such a character that the student may properly defer their consideration until he is prepared to pursue a course in cost accounting. It is proper, therefore, to consider next some of the most commonly used forms employed in connection with selling or marketing.

### MARKETING

Marketing is that activity whereby merchandise manufactured, or otherwise secured, is sold. The marketing function is of great importance. Unless a sufficient volume of sales can be achieved, it is impossible to make a profit because fixed charges, such as interest and depreciation, cannot be reduced. It is possible only to mention some of the more important aspects of the work of the marketing function.

In case of retail establishments, it is the almost universal custom when a sale is made, whether for cash or on account, for the sales clerk to make out a sales ticket in duplicate. This is usually done by having the sales tickets printed in pads and numbered consecutively. Thus the original ticket may be on white paper and the duplicate on yellow paper. A carbon paper is inserted between these in order to permit making both copies with one writing.

The purpose of the sales ticket is to provide the vendor with a record. The duplicate is given to the vendee. The vendee may preserve all duplicates and compare them with the monthly statement sent him at the close of the month. If the sale is on account, the original copy of the sales ticket kept by the vendor serves as a basis for charging the vendee's account on the vendor's books. If the sale is for cash, the ticket serves as a basis for making an entry for cash sales for the day. Sometimes, in case of cash sales, the only record the customer receives is a slip printed in a cash register. Cash registers are so devised as to make sales distributions according to whatever divisions may seem necessary. In Fig. 105 is shown a form of sales ticket.

**ONE-STOP SERVICE STATION**

Phone 1144 Cor. Dufrocq and Spain St.

Baton Rouge, La.,____________________19____

M____________________________

Address____________________________

| | | | |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

Received by____________________________

Fig. 105

**MONTHLY STATEMENT**

**One-Stop Service Station**
**Corner Dufrocq and Spain Street**
**Baton Rouge, Louisiana**

Date____________________

Sold To____________________

Address____________________

Monthly Settlements Required

| | Items | Details | Total |
|---|---|---|---|
| | Balance Forward | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

Fig. 106

Delivering goods is an important part of marketing. Today there are many agencies which may be employed for this purpose. The merchant may own his own delivery equipment or he may depend upon various specialized agencies whose services he can employ, such as parcel post, the railroad express, motor transports, freight services of various kinds, air transportation, etc.

When a concern sells to a customer frequently during the month, it is customary to summarize the sales at the end of the month by sending to the customer a monthly statement. Thus, the One-Stop Service Station would send to each credit customer at the end of the month a monthly statement similar to the one shown in Fig. 106.

In connection with the shipping of merchandise, various papers are employed, depending upon the manner in which the goods are shipped. Thus, if shipment is made by freight, a bill of lading is issued. Bills of lading are of two kinds, straight and order. Order bills of lading are negotiable, whereas straight bills of lading are not negotiable. Bills of lading are issued in triplicate. The shipper receives the original copy, the transportation company keeps the second copy, and the third copy is sent to the buyer.

If goods are sent by express, the shipper receives an express receipt which he keeps until he learns that the goods have been delivered in proper condition.

Frequently goods are shipped to customers and a sight draft is attached to the order bill of lading which is sent to a bank situated in the town in which the vendee resides. The bank upon receipt of these papers notifies the vendee who secures the bill of lading by paying the sight draft. He is thus enabled to secure the goods.

## CONTROLLING

The controlling function is concerned primarily with accounting. For this reason the officer in charge of the accounting work is sometimes called the controller. Since accounting is the subject matter of this book, detailed attention need not be given here to the controlling function. Its position in the general organization of the business may, however, be noted. It may be regarded as coordinate with other primary functions of the business or it may

be made subordinate to the financing function. The controlling function bears a heavy responsibility toward the other functions in the sense that it must afford accurate information relative to all costs and expenses. Great benefits result through proper coordination of the functions of the controlling division with the functions of other divisions.

## FINANCING

The financing function of a business is concerned with the problem of providing adequate funds for operation. It is evident that business itself must provide funds needed for current requirements. This results from the turnover of merchandise at a price in excess of all costs, thus providing a margin of profit. There are occasions, however, when this normal provision of capital through operations does not meet the requirements. For example, if a concern is about to launch upon a program of expansion, requiring the expenditure of large sums of money in the construction of new buildings and equipment, it may be necessary to make special arrangements. These arrangements usually take the form of sales of bonds or stocks, but sometimes temporary arrangements may be made by securing large sums of money from banks, these obligations in turn being liquidated when securities are sold.

There are, of course, current problems constantly arising which require the attention of the officer in charge of financing—usually the treasurer. He must so manage that there is always a sufficient amount of cash in the bank and on hand to meet current requirements. Owing to seasonal variations in sales and purchases temporary shortages of cash may necessitate the making of short-term loans at banks. This is a service which banks are expressly fitted to perform and for which the charge is usually reasonable.

To summarize, it may be stated that the financing function is one of great importance as a means of providing for the current operations of the business and as a means of arranging for unusual requirements from time to time.

Financing bears a close relationship to accounting since it depends upon accounting for accurate information relative to the handling of all funds.

**PERSONNEL**

Detailed attention need not be given to the personnel function. The man in charge of personnel has as his duty the employment of men, their welfare during employment, and their dismissal or retirement. Much depends upon the efficiency with which the personnel function is operated. The cost of a high rate of labor turnover is large. An efficiently organized business will usually see to it that this cost is reduced to a minimum.

**Negotiable Instruments.** Thus far, attention has been given only to papers used to promote transactions but which are of no

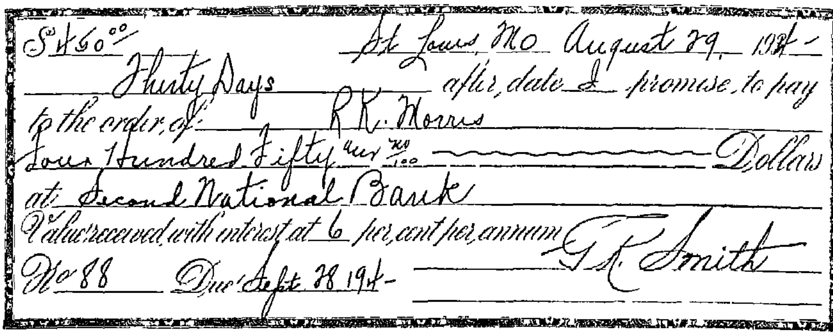

$450.00 St Louis, Mo August 29 192–
Thirty Days after date I promise to pay
to the order of R. K. Morris
Four Hundred Fifty and 00/100 Dollars
at Second National Bank
Value received with interest at 6 per cent per annum
No 88 Due Sept 28 192– G. K. Smith

Fig. 107

value in themselves. This is true, for example, of sales tickets and invoices. It is now necessary to give some attention to papers which actually represent wealth and which in a sense tend to increase the amount of available money. As a result of long experience, what are known as negotiable instruments have come to occupy an important place in business. At least 90 per cent of all business transactions in the United States involve the use of credit instruments. The essential factor of a negotiable instrument is that it may be transferred readily from person to person and thus may be made to serve as a means of transferring wealth. Many contracts are assignable but are not negotiable. The following types of negotiable instruments will be discussed: (1) notes, (2) drafts, (3) checks, (4) trade acceptances.

1. *Notes.* The Uniform Negotiable Instruments Law defines a

promissory note as "an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money, to order or to bearer." A form of promissory note is shown in Fig. 107.

The promissory note illustrated in Fig. 107 can be negotiated by R. K. Morris in one of several ways. If he writes the following on the back of the instrument:

> *Pay to Ronald Green or order*
> *R. K. Morris*

he is said to have made a special indorsement in favor of Ronald Green. The transferee, Ronald Green, will have to indorse it before it can be negotiated again. The protective feature of such an indorsement is obvious.

If Morris indorses the back of the note as follows:

> *R. K. Morris*

he is said to have indorsed in blank. This indorsement makes the instrument payable to bearer and is perhaps the most common form of indorsement. After such an indorsement has been made, the instrument may be transferred from hand to hand without further indorsement, but for purposes of additional security it is usually required of each holder that he indorse before transferring the instrument to the next party.

If R. K. Morris indorses as follows:

> *Without recourse*
> *R. K. Morris*

he is said to make a qualified indorsement. He transfers title to the instrument but avoids liability thereon. He becomes a mere assignor. The negotiability of the instrument is not impaired by such an indorsement. If R. K. Morris indorses as follows:

> *Pay to O R Best for*
> *collection*
> *R. K Morris*

he is said to have made a restrictive indorsement. Under the Uniform Negotiable Instruments Law a restrictive indorsement is one which "(1) prohibits further negotiation of the instrument, or (2) constitutes the indorsee the agent of the indorser, or (3) vests the title in the indorsee in trust for or to the use of some other person."

If R. K. Morris indorses as follows:

> *Pay to order of G K. North*
> *upon completion of West Stadium*
> *R K. Morris*

he is said to have made a conditional indorsement. The Uniform Negotiable Instruments Law states that "where an instrument is conditional, a party required to pay the instrument may disregard the condition and make payment to the indorsee or his transferee, whether the condition has been fulfilled or not. But any person to whom an instrument so indorsed is negotiated, will hold the same, or the proceeds thereof, subject to the rights of the person indorsing conditionally."

2. *Drafts.* The Uniform Negotiable Instruments Law defines a draft or bill of exchange as "an unconditional order in writing addressed by one person to another, signed by the person giving it,

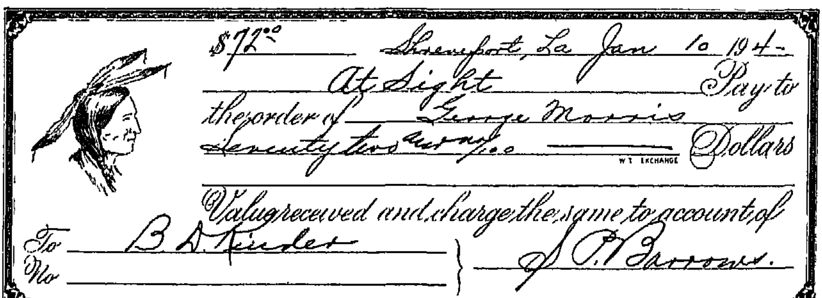

$72.00 Shreveport, La Jan 10 194-
At Sight Pay to
the order of George Morris
Seventy two 00/100 Dollars
W T EXCHANGE
Value received and charge the same to account of
To B. A. Kinder
No
S. P. Barrows.

Fig. 108

requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to order or to bearer."

Los Angeles, Cal, June 2, 19—

**The ABC National Bank**

Pay to the order of *Arthur Gould* . *$25.00*

*Twenty-Five and 00/100* Dollars.

**To CDE National Bank**
**New York, N. Y.**

C. D York, Cashier

Fig. 109

According to place of payment drafts are foreign or inland. A foreign draft or bill of exchange is one payable in a country or state other than that in which it was drawn. As to time of payment, drafts may be classified variously. A sight draft is one payable upon presentation. A time draft is one which is payable after a certain length of time has expired. A form of sight draft is shown in Fig. 108 and in Fig. 109 is shown a form of sight draft drawn on a bank.

3. *Checks.* The Uniform Negotiable Instruments Law defines a check as "a bill of exchange drawn on a bank payable on demand."

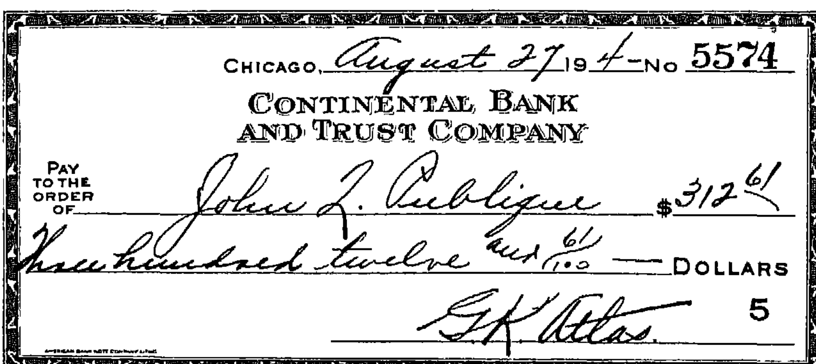
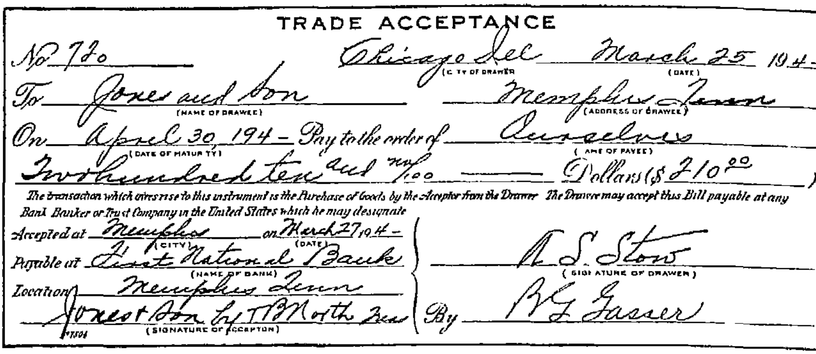

CHICAGO, August 27 194- No 5574
CONTINENTAL BANK AND TRUST COMPANY
PAY TO THE ORDER OF John L. Publique $312 61/
Three hundred twelve and 61/100 DOLLARS
G. K. Atlas
5

Fig. 110

Checks are subject to practically the same legal rules as are other drafts. A form of check is shown in Fig. 110. A cashier's check is one drawn against a bank and signed by the cashier of the bank. Cashiers' checks are used by the bank in paying its own obligations and also to remit sums of money for other purposes.


TRADE ACCEPTANCE

No 780 Chicago Ill March 25 194-
(City of Drawer) (Date)

To Jones and Son Memphis Tenn
(Name of Drawee) (Address of Drawee)

On April 30 194- Pay to the order of Ourselves
(Date of Maturity) (Name of Payee)

Two hundred ten and no/100 Dollars ($210.00)

*The transaction which gives rise to this instrument is the Purchase of Goods by the Acceptor from the Drawer. The Drawer may accept this Bill payable at any Bank Banker or Trust Company in the United States which he may designate*

Accepted at Memphis on March 27 194-
(City) (Date)

Payable at First National Bank R S Stow
(Name of Bank) (Signature of Drawer)

Location Memphis Tenn

Jones & Son by T B North Treas By R G Fraser
(Signature of Acceptor)

Fig 111

4. *Trade Acceptances.* A trade acceptance is a bill of exchange drawn by the seller on the buyer of the goods sold and accepted by such buyer. The distinguishing characteristic is the fact that it contains on its face a statement to the effect that it arises out of the purchase of goods by the acceptor. This makes the instrument more readily available for rediscount purposes. A form of trade acceptance is shown in Fig. 111.

# *Chapter* 11

# ACCOUNTING FOR NOTES AND DRAFTS

In Chapter 10 a discussion of notes, drafts, and checks was presented, but no attempt was made to explain the accounting treatment of these important instruments. In some lines of business the open account serves most of the credit purposes in buying and selling, but in other lines of business it is the custom to employ so-called credit instruments. For example, sales of retail stores on account are made almost invariably without the use of notes and drafts, the expectation being that settlement will be made in a relatively short period of time, usually 30 days. It is notably difficult, however, to discount or sell open accounts receivable; so where it is desirable to avoid tying up too much capital in customers' accounts it may be necessary to employ credit instruments which can be discounted readily and perhaps rediscounted.

To illustrate, suppose that a sale amounting to $100.00 is made to John Jones on open account. The only practicable procedure is to retain Jones's account on the concern's books until he pays. Even if all accounts are settled, say, in 30 days, there results a considerable investment in the form of such accounts. Now suppose that instead of selling to Jones on open account, the concern requires Jones to give his note for $100.00 due in 30 days without interest. Such a note is readily discountable at the concern's bank, and if the concern is in need of working capital it can discount as many such notes as it has available. The trade acceptance can be used in much the same way as the note and in some respects is even superior to the note since it is subject to rediscount by the bank. In other words, the trade acceptance not only helps to keep the concern's working capital in liquid form, but it also makes it possible for the bank to keep its assets in liquid form.

It is true that there are financial companies which make a prac-

tice of purchasing or discounting open accounts receivable; however, business men are averse to having recourse to such companies except as a last resort because the sale or discount of customers' accounts is regarded as undesirable practice and an indication of poor credit standing.

Whether or not specially designed records must be used in connection with notes, drafts, and trade acceptances depends upon the frequency with which such instruments are employed. Some explanation of such records will be found later on in this chapter.

**Notes Receivable.** Notes receivable are accepted at the time a sale is made, and the amount of the note is ordinarily the amount of the transaction. A note receivable may or may not bear interest from date. If it does not bear interest from date, it is understood that it begins to bear interest at maturity in case the maker fails to pay at maturity. A noninterest-bearing note is therefore worth something less than its face value, since the holder of the note must wait until maturity to collect. If the note bears interest from date, it may or may not be worth its face value, depending upon the rate of discount used to determine its present worth. The time element for most notes is not sufficiently important to make it impossible to regard the face value of the note as its present value. A series of illustrations will be presented for the purpose of explaining the accounting principles involved in their treatment.

*Illustration 1.* Assume that the Sullivan Company sells merchandise wholesale under three possible arrangements, namely, (a) open account, (b) taking the customer's note, and (c) taking the customer's trade acceptance. To illustrate each of these procedures three sales are assumed, as follows:

1. A sale to G. B. North on open account, \$50.00, terms 2/10, n/30.
2. A sale to H. K. Best, \$200.00. Best's note for \$200.00 is due in 30 days, without interest being taken.
3. A sale to George Morris for \$75.00. Morris accepts a trade acceptance sent him by the Sullivan Company. This acceptance is payable 60 days after date.

The entries on the books of the Sullivan Company are as follows:

| | | |
|---|---|---|
| (1) | | |
| *G. B. North (Accounts Receivable)* | *50.00* | |
| *Sales* | | *50.00* |
| *For sale on account, terms 2/10, net 30.* | | |
| (2) | | |
| *Notes Receivable* | *200.00* | |
| *Sales* | | *200.00* |
| *For sale to H. K. Best, his note due in 30 days without interest being taken.* | | |
| (3) | | |
| *Trade Acceptances Receivable* | *75.00* | |
| *Sales* | | *75.00* |
| *For sale to George Morris, his acceptance due in 30 days being taken.* | | |

It is unnecessary to indicate in detail the entries to be made in each of the three cases if payment is received at the proper time.

*Illustration 2.* When G. B. North pays his account in full within the discount term the entry is as follows:

| | | |
|---|---|---|
| *Cash* | *49.00* | |
| *Sales Discount* | *1.00* | |
| *G. B. North (Accounts Receivable)* | | *50.00* |
| *For payment in full.* | | |

When H. K. Best pays his note at maturity the entry is:

| | | |
|---|---|---|
| *Cash* | *200.00* | |
| *Notes Receivable* | | *200.00* |
| *For payment in full of note.* | | |

When George Morris pays his acceptance at maturity the entry is:

| | | |
|---|---|---|
| *Cash* | *75.00* | |
| *Acceptances Receivable* | | *75.00* |
| *For payment of acceptance.* | | |

*Illustration 3.* It is possible that the Sullivan Company may find it necessary to obtain additional funds before any of the obligations received in Illustration 2 mature. It then becomes necessary to determine what procedure can be followed to secure funds. As has been explained, it is usually both difficult and undesirable to attempt to sell open accounts, therefore the Sullivan Company is not likely to do anything with G. B. North's open account. The note received from Best can be discounted but it is not available for rediscount at a bank. The trade acceptance received from

Morris can be discounted and rediscounted and therefore represents the most desirable means of obtaining funds, providing the amount thereof is sufficient. If the company decides to discount Best's note and the discount amounts to $3.00, the entry is as follows:

| | | |
|---|---|---|
| *Cash* . . . . | *197 00* | |
| *Interest Expense* . . . | *3 00* | |
| *Notes Receivable Discounted.* | | *200 00* |
| *For discount of note of H K Best due————————.* | | |

If the Sullivan Company decides to discount the trade acceptance given by George Morris, the entry is practically the same as for the note shown above, except that the credit may be made to an Acceptances Receivable Discounted account instead of to a Notes Receivable Discounted account. In event of the discounting of either the note or the acceptance the Sullivan Company must indorse the instrument and thus render itself contingently liable thereon. This contingent liability ceases if the party primarily liable on the instrument pays it at maturity.

Suppose that in the foregoing illustration Best fails to pay the note at maturity and that the Sullivan Company is compelled to pay the bank. In that case the following entry is required on the books of the Sullivan Company:

| | | |
|---|---|---|
| *Notes Receivable Discounted* | *200.00* | |
| *Cash* . . . | | *200 00* |
| *For payment of dishonored note of H. K. Best.* | | |

The Sullivan Company must now decide whether it will continue to carry Best's note in the Notes Receivable account or whether it will charge the amount of the note back to Best's open account. If it is decided to continue the obligation in the form of notes receivable, it may be desirable to transfer it to an account entitled Notes and Acceptances Receivable Past Due account. The entry to accomplish this would be:

| | | |
|---|---|---|
| *Notes and Acceptances Receivable Past Due* . . . | *200 00* | |
| *Notes Receivable* . . . . | | *200 00* |
| *To Transfer dishonored note to proper account.* | | |

If, on the other hand, it is decided to charge the amount of the note back to Best's open account the entry is as follows:

| | | |
|---|---|---|
| *H K Best (Accounts Receivable)* | *200 00* | |
| *Notes Receivable* | | *200 00* |
| *To charge dishonored note to Best's open account* | | |

*Illustration 4.* When a note is dishonored, it is necessary to pay certain expenses connected with the handling of the dishonored note. As a rule, such notes are protested and the person or concern compelled to pay the note must pay the protest fees also. To illustrate, assume that John Jones accepts from George Watkins the note of Alexander Brown in settlement of a debt of $300.00. The note does not bear interest. At maturity it remains unpaid, and in order to hold the indorser, George Watkins, it is necessary for John Jones to protest the note. Assuming that the protest fee amounts to $1.00 and that John Jones decides to charge the note to the open account of Alexander Brown, the following entry is made on John Jones's books:

| | | |
|---|---|---|
| *Alexander Brown (Accounts Receivable)* | *301.00* | |
| *Notes Receivable* | | *300 00* |
| *Cash.* | | *1 00* |
| *To charge dishonored note and protest fees to the account of Alexander Brown.* | | |

Since Jones has paid a note upon which Watkins is liable as indorser, he may sue Watkins, and if he recovers he should make the following entry:

| | | |
|---|---|---|
| *Cash . . . . . . . . . . . . . . .* | *301 00* | |
| *Alexander Brown (Accounts Receivable)* | | *301.00* |
| *For amount recovered from George Watkins as indorser on note of Alexander Brown* | | |

When Watkins pays this amount he charges it to the account of Alexander Brown from whom he must collect. The entry on Watkins' books is as follows:

| | | |
|---|---|---|
| *Alexander Brown (Accounts Receivable) . . . . .* | *301 00* | |
| *Cash . . .* | | *301.00* |
| *For payment of dishonored note of Alexander Brown.* | | |

**Notes Payable.** Notes payable represent the liability of the issuing concern, whereas notes receivable are assets. Perhaps the two most frequent uses of notes payable are: (*a*) to reflect indebtedness for the purchase of merchandise or other materials and (*b*) to make use of bank credit.

*Illustration 1.* Assume that Gessler and Son purchase merchandise from the Southern Wholesale Company and give a note due in two months for the amount of the purchase, $400.00, with interest from date at 6 per cent. When the note is issued, the entry is as follows:

| | | |
|---|---|---|
| *Purchases* | *400.00* | |
| *Notes Payable* | | *400.00* |
| *Note due in two months to Southern Wholesale Company, interest from date at 6 per cent.* | | |

When the note is paid at the end of the period of two months, the entry is:

| | | |
|---|---|---|
| *Notes Payable* | *400.00* | |
| *Interest Expense* | *4.00* | |
| *Cash* | | *404.00* |
| *For payment of note given to Southern Wholesale Company.* | | |

Of course, if the Southern Wholesale Company has negotiated the note by discounting it at a bank or transferring it to a third party, payment will be made to the person who owns the note. It is the duty of the person who owns the note to present it for payment. If the note indicates a place at which payment shall be made, the holder must be prepared to accept payment at such place.

*Illustration 2.* One of the principal functions of commercial banks is to discount notes and acceptances for customers, thus affording the capital required to bridge periods of financial stringency. Such stringency frequently is seasonal in character, passing upon the disposition of the merchandise the purchase of which is made possible by securing credit at banks. When a commercial bank discounts paper for its customers, its profit is derived in the form of the discount which it charges for the service which it performs. If the amount loaned by the bank is large, it will require some form of security from the borrower. The borrower's promise is reduced to the form of a note payable which specifies the terms of the loan. The bank discounts this note by first computing the interest thereon at the agreed rate and then deducting this interest from the amount of the note. The difference, or proceeds, is then credited to the customer's checking account or is paid to him in cash.

If the note discounted bears interest from date, the amount upon which the bank discount is computed is found by adding the inter-

est, from date to date of maturity, to the principal of the note. This is the amount which the bank then discounts. If the note does not bear interest, the bank discount is computed on the face amount of the note. Interest rates and discount rates are not necessarily the same. A note may be discounted at any time between date of issuance and date of maturity.

*Illustration 3.* John Jones accepts from R. T. Norris a note for $500.00 due in three months without interest. After one month Jones discounts the note at a bank, the discount rate being 7 per cent. The entry is as follows:

| | | |
|---|---|---|
| *Cash* | *494.17* | |
| *Interest Expense* | *5.83* | |
| *Notes Receivable Discounted* | | *500.00* |
| *To discount Norris' note due in two months, the discount rate being 7 per cent.* | | |

*Illustration 4.* To show the procedure in case the note bears interest from date, it may be assumed in the preceding illustration that the note bears interest at 6 per cent and that it is discounted at 7 per cent. The entry is as follows:

| | | |
|---|---|---|
| *Cash* | *501.58* | |
| *Interest Expense* | *5.92* | |
| *Interest Income* | | *7.50* |
| *Notes Receivable Discounted* | | *500.00* |
| *For note of R. T. Norris, due in 3 months, bearing interest at 6 per cent, and discounted 2 months before maturity at 7 per cent.* | | |

When Norris pays the note, John Jones makes the following entry:

| | | |
|---|---|---|
| *Notes Receivable Discounted* | *500.00* | |
| *Notes Receivable* | | *500.00* |
| *For R. T. Norris' note paid at bank.* | | |

Should Norris fail to pay the note at maturity Jones makes the following entry:

| | | |
|---|---|---|
| *Notes Receivable Discounted* | *500.00* | |
| *Interest Income* | *7.50* | |
| *Cash* | | *507.50* |
| *For payment of dishonored note of R. T. Norris.* | | |

Next, it is necessary for Jones to charge the account of R. T. Norris, as follows:

| | | |
|---|---|---|
| *R. T. Norris (Accounts Receivable)* | 507.50 | |
| *Notes Receivable* | | 500.00 |
| *Interest Income* | | 7.50 |
| *To charge dishonored note of R. T. Norris to his personal account.* | | |

**Drafts.** Drafts are either time drafts or sight drafts. A time draft is one payable at a specified time after date of issuance, or after date of acceptance. A sight draft is one which is payable upon presentation. Checks are a form of sight draft, being payable upon presentation at the bank on which they are drawn. Acceptance is necessary to fix liability on time drafts, but it is not necessary to fix liability on sight drafts.

When the drawee of a bill of exchange accepts it, this is indicative of his willingness to pay. An acceptance must be in writing and must be signed by the drawee. The acceptance must be to pay in money. The acceptance is not effective until the acceptor redelivers the bill to the holder or notifies him of the acceptance. The word *acceptance* ordinarily means acceptance completed by delivery or notification. A general acceptance is one which assents to the order of the drawer without any qualification. A qualified acceptance is one which changes the effect of the bill as drawn. The accounting treatment of sight drafts and of time drafts will be illustrated.

*Illustration 1.* Since no entry is necessary in connection with sight drafts until payment is made, no accounting problem arises other than that which is connected with the receipt and disbursement of cash. Perhaps the most common use of the sight draft is in connection with the shipment of goods which are to be released by the transportation company only upon presentation of a bill of lading by the buyer. The bill of lading with sight draft attached is sent to the buyer's local bank, which in turn notifies the buyer. He then appears at the bank, pays the sight draft, and secures the bill of lading. It is evident that this amounts to nothing more than cash payment for the goods and should be so treated on the buyer's books. To illustrate, assume that Smith and Brown, in St. Louis, receive an order for a shipment of merchandise amounting to $500.00, from Lord and Lord, in Mobile. The Smith and Brown Company ship goods to Mobile and send the bill of lading with sight draft attached to a Mobile bank. The bank notifies Lord and Lord, who then pay the draft and secure the bill of lading. The bank

deducts its commission from the amount received and then remits to Smith and Brown the proceeds. Smith and Brown make the following entry, assuming that the bank deducts $1.00 to cover collection costs.

| | | |
|---|---|---|
| *Cash* | *499.00* | |
| *Collection Expense* | *1.00* | |
| *Lord and Lord (Accounts Receivable)* | | *500.00* |
| *For sight draft of Smith and Brown paid at Mobile National Bank.* | | |

*Illustration* 2. When time drafts are used the liability of the drawee dates from his acceptance of the draft; therefore no entry need be made on the books of any of the parties involved until acceptance occurs.

To illustrate, assume that Morris and Son sell merchandise, $1,000.00, to Arthur Sullivan. Sullivan draws a draft on James Eastman, due 60 days after acceptance. James Eastman accepts on January 15, which makes the date of maturity March 16. The entries on the books of the parties involved at date of acceptance are shown below.

(1) On books of payee (Morris and Son):

| | | |
|---|---|---|
| *January 15* | | |
| *Notes Receivable* | *1,000.00* | |
| *Arthur Sullivan (Accounts Receivable)* | | *1,000.00* |
| *For draft due March 16, accepted by James Eastman.* | | |

(2) On books of drawer (Arthur Sullivan):

| | | |
|---|---|---|
| *January 15* | | |
| *Morris and Son (Accounts Payable)* | *1,000.00* | |
| *James Eastman (Accounts Receivable)* | | *1,000.00* |
| *For draft accepted by James Eastman on January 15, payable to Morris and Son, maturing March 16.* | | |

(3) On books of drawee (James Eastman):

| | | |
|---|---|---|
| *January 15* | | |
| *Arthur Sullivan (Accounts Payable)* | *1,000.00* | |
| *Notes Payable* | | *1,000.00* |
| *For draft accepted for Arthur Sullivan payable to Morris and Son on March 16.* | | |

When James Eastman pays the draft on March 16, the entries are as follows:

(1) On books of payee (Morris and Son):

| | | |
|---|---|---|
| | *March 16* | |
| *Cash* | 1,000.00 | |
| *Notes Receivable* | | 1,000.00 |

(2) On books of drawer (Arthur Sullivan):

No entry.

(3) On books of drawee (James Eastman):

| | | |
|---|---|---|
| | *March 16* | |
| *Notes Payable* | 1,000.00 | |
| *Cash* | | 1,000.00 |

In the event that James Eastman fails to pay the draft at its maturity, March 16, Morris and Son will have the draft protested. This protesting serves as official recognition that the note has been dishonored. In order that the party secondarily liable, that is, Arthur Sullivan, may be held, it is necessary that the notary public before whom the draft was protested give him notice. The entries at this time on the books of the various parties are as follows:

(1) On books of payee (Morris and Son):

| | | |
|---|---|---|
| | *March 16* | |
| *Arthur Sullivan (Accounts Receivable)* | 1,002.00 | |
| *Notes Receivable* | | 1,000.00 |
| *Cash* | | 2.00 |
| *For dishonored draft and protest fees charged to drawer.* | | |

(2) On books of drawer (Arthur Sullivan):

| | | |
|---|---|---|
| | *March 16* | |
| *James Eastman (Accounts Receivable)* | 1,002.00 | |
| *Cash* | | 1,002.00 |
| *To charge dishonored draft and protest fees to drawee.* | | |

(3) On books of drawee (James Eastman):

No entry.

# *Chapter* 12

# THE CORPORATION

**Nature of the Modern Corporation.** The modern corporation is the result of an evolutionary process which has had as its purpose the devising of a form of business organization suitable to the requirements of industry and trade. Since corporations exist only by consent of the state, the manner in which their formation and control are provided for in the laws of the state is a matter of importance. Formerly, corporations were organized only by special act of legislature, but today all of the 48 states have so-called general incorporation laws. These vary greatly as to content, but the student who investigates them will find that a few states are leaders in the way of introducing new methods of control. Naturally, these leading states are the ones in which there has occurred a large degree of commercial or industrial development.

Modern industry is of such a character as to make necessary the employment under one management of great amounts of capital. Sometimes millions of dollars are thus employed. This means that the management of capital is not exercised by the owners. As a result, it becomes necessary to devise forms of organization which can be well managed even though they employ millions of dollars in their activities. Most of these organizations must be able to report satisfactorily to the real owner of the capital which they employ. In sole proprietorships most of the capital is provided by the proprietors and this is largely true also of partnerships. The corporation is peculiarly adapted to the requirements of present-day society because it enables all classes of people to become owners of industry. It is because of this situation that it is necessary for the student of accounting not only to understand those accounting procedures which are peculiar to the corporation, but also to have some knowledge of the manner in which corporations are formed and operated.

The student will do well to memorize the famous definition written by Chief Justice Marshall: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law." This means that a corporation is created by man through the enactment of proper laws. It also means that corporations are legal in character, being dependent upon the laws under which they are created. It may be surprising to learn that corporations are invisible and intangible, but this is true. The possessions of a corporation are visible and tangible, but the corporation itself is not.

**Incorporation Procedure.** Sometimes corporations are incorporated in states other than the states in which they operate, but this is the exception rather than the rule. Of course, where a corporation does business in several states, it becomes more or less a matter of choice as to which state shall be chosen for incorporation purposes. There are several considerations involved in arriving at a choice. In some states the tax burden is heavier than in other states. Other things being equal, the state imposing the least amount of tax will be chosen. There are, however, other important factors. Some states are quite liberal in the grant of powers which they make to the corporation. Here again the state which grants the wider powers is likely to be chosen. Some states require more extensive reports than do others. Naturally, since the preparation of reports is costly, states requiring elaborate reports are not likely to be favored for incorporation purposes. The general character of the state's legislation relative to corporations must be taken into consideration. In some states this legislation will be found to be progressive and up to date; in other states it may be found to be antiquated and inadequate. As a rule, three incorporators are required. Each of these must be of age and must be competent to contract.

**The Corporation Charter.** The charter, or articles of incorporation, is a contract between the corporation and the state. It is necessary to file an application for a charter with the secretary of state. Sometimes this application is known as the articles of incorporation. The secretary of state may provide blank forms for this purpose, but this is not necessarily the case. In some states, for example, the application is simply a typewritten document which becomes the charter when it has been approved by the secretary of

state. The state in which incorporation is sought will require the submission of certain information relative to the proposed corporation. Since the information thus required differs in different states, the following should be regarded merely as typical, not as illustrative, of procedure in any particular state.

1. The name of the corporation must be stated. Care should be taken to see that this does not conflict with the name of any other corporation in the state in question.

2. The object or objects for which the corporation is to be formed must be explained. Corporations cannot be established to carry on illegitimate work, and they must also limit their activities to the powers prescribed in the charter.

3. The requirements of the corporation as regards capital stock must be set out in the application for a charter. This request for capital stock must be in accordance with the provisions of the state law. The state law will indicate what classes of stock may be issued as, for example, stock having a par value and stock having no par value. The amount of stock authorized in the charter is the amount which the corporation may issue. Any stock issued in excess of the amount authorized is invalid. The number of shares of stock of each class and the par value thereof, if the stock has a par value, must be indicated. If the stock is of no par value, the facts relative thereto must likewise be set forth.

4. Most states provide that a corporation cannot begin business unless it has a minimum paid-in capital stock. Thus if the minimum paid-in capital stock is set at $1,000.00, this means that stock having a value of $1,000.00 must be sold in order to provide funds for operation. Unless this amount of stock can be sold the corporation cannot come into existence.

5. The location of the office of the corporation must be stated in the application. This must be somewhere in the state of incorporation, but business offices of the corporation may be established in other states.

6. The provisions of the state law relative to corporate duration must be adhered to. Some states grant charters in perpetuity, others definitely limit the life of the corporation.

7. The names and addresses of the incorporators must be given together with the number of shares of stock to which each subscribes. It may be required also to state the names and addresses of the directors. If the state law prescribes a minimum number of directors such requirement must be adhered to.

The fee charged by the state for incorporation is usually made a percentage of the par value of the stock or a given amount per share of the capital authorized. The application for a charter becomes a contract when it has been approved by the secretary of state. This contract has as parties the state on the one hand and the corporation on the other hand. The provisions of the charter must be adhered to by the corporation, otherwise the charter may be withdrawn by the state. Amendment of the charter involves much the same procedure

as obtaining the original charter, and a fee is required in this connection.

After the corporation has been established, it is necessary to hold an organization meeting at which by-laws are adopted. The by-laws may be said to supplement the charter and must be in agreement with the charter as well as with the constitution of the state. Details which cannot be properly incorporated in the charter may be properly incorporated in the by-laws. It may be said, therefore, that the charter sets forth the fundamental facts relative to incorporation, whereas the by-laws contain details specifying how officers shall be elected and dismissed, as well as indicating their duties. Also, there may be detailed specifications relative to matters of internal management of the corporation. The following quotation is from *Private Corporations*, section 639, by Clark and Marshall: "The office of by-laws is to prescribe rules for the government of the corporation, and to regulate the conduct and define the duties of the members towards the corporation and between themselves."

The purpose of by-laws is not to give the corporation additional powers, but to enlarge upon the powers granted by the charter by specifying in detail how such powers may be exercised. The by-laws may, however, limit powers granted by the charter, as, for example, prohibiting officers from performing acts which fall within the powers conferred by the charter.

Certain rules may be followed to test the validity of any particular by-law. These are: (1) reasonableness, (2) consistency with charter, (3) legality, (4) vested rights of stockholders which cannot be impaired by by-laws, (5) manner of adoption. To be valid, by-laws must be adopted in the manner prescribed in the charter or in the laws of the state.

Detailed provisions which should appear in the by-laws are:

1. The time and place of the annual meeting as well as provision for special meetings.
2. What shall constitute a quorum at meetings of stockholders and how stockholders' meeting shall be organized.
3. How voting shall be carried on at meetings of stockholders.
4. The number of directors and the term of their office When and where meetings of the board of directors shall be held and how notice of such meetings shall be given.

5. How a quorum shall be determined at meetings of directors.
6. How contracts may be made and approved.
7. The appointment and tenure of the various officers, such as president, vice-president, treasurer, secretary, and controller.
8. How checks and drafts shall be issued.
9. How certificates of shares of stock shall be signed.
10. How dividends shall be paid and the policy of the corporation in this connection relative to preserving sufficient working capital.
11. How the by-laws may be amended.
12. Corporate policies relative to indebtedness.
13. Corporate policies relative to expansion of plant and equipment.

**Classes of Corporations.** Corporations may be classed in various ways. Only a few of these will be indicated here. As regards the relationship which corporations bear to the public, they may be classified as: (1) public corporations, (2) private corporations.

A public corporation is one which is organized to carry on a function essential to the public welfare, such as the governments of cities, counties, and states. Public utilities which are privately owned are not public corporations. A private corporation is one owned by individuals and operated for their profit. In this group may be included most of the corporations which are engaged in manufacture, trade, and transportation.

As regards the manner in which corporations are owned, they may be classed as: (1) stock corporations, (2) nonstock corporations.

In a stock corporation ownership is evidenced by shares of stock. Most of the corporations which carry on the country's business are of this type. Nonstock corporations are not organized for profit. Frequently, they are owned by the public, but there are many exceptions to this rule. Illustrations of nonstock corporations are hospitals and libraries.

As regards the state of incorporation, corporations are either: (1) domestic, (2) foreign.

A corporation is said to be domestic in the state in which it is incorporated and foreign in other states; thus a corporation organized in Missouri is domestic in Missouri but foreign in Illinois.

**Capital Stock.** The capital stock system is employed by practically all corporations engaged in business for profit. Notwithstanding criticisms which may be passed upon it, it possesses distinct advantages. Capital stock is synonymous with ownership, and

if one person owned all of the capital stock of the corporation, he would be the sole owner. Capital stock should be distinguished from capital stock certificates which are simply the evidence of stock ownership. If a capital stock certificate should be destroyed, the interest of the stockholder in the corporation would not be affected. The division of capital stock into shares makes it possible to secure wide distribution of ownership. A stock certificate may represent one or many shares of stock.

The amount of the authorized stock is expressed in the charter. The amount authorized is the amount which can be issued, but the entire amount authorized need not be issued. It is sometimes a matter of convenience to have authorized but unissued stock which can be sold when an emergency makes necessary additional funds.

The creditors of a corporation are entitled to consider the outstanding capital stock as a fund for their protection. This has given rise to the trust fund theory of capital stock, in accordance with which the capital stock is regarded as a fund held in trust for the payment of the company's debts, should it be unable to meet these debts in the usual manner. This theory is no longer looked upon as an absolute principle, but rather as a rule of procedure.

Frequently, the expression *stated capital* is encountered. It is the sum below which capital cannot be reduced without incurring personal liability for debts on the part of those who authorize the reduction.

Much has been said about the impairment of capital stock through payment of dividends. Many of the state statutes contain provisions prohibiting use of anything except surplus to pay dividends. The purpose of such statutes is to prevent the impairment of capital.

Capital stock is the means to an important end, namely, the acquisition of cash, property, and services required in the prosecution of the work for which the company is organized. There is an important technical difference between capital and capital stock which the student of accounting must recognize. Capital is the excess of assets over liabilities. This may be either greater or less than the amount of the capital stock. It is possible that at the very commencement of a business capital stock and capital may be of equal amount, but this is a condition which soon changes because of the accumulation of profit or the incurring of a deficit.

Capitalization must also be distinguished from both capital and capital stock. The term usually means the capital of a company plus its bonded indebtedness. The expression *capital structure* is sometimes used to mean the same as capitalization. The capitalization of a certain important American concern as stated in a recent corporation report is as follows:

| | |
|---|---|
| *Funded Debt* | $10,600,000.00 |
| *7½% Accumulative Preferred Stock* | 5,627,300.00 |
| *7% Preferred Stock* | 642,700.00 |
| *Special Employee's 8% Preferred Stock* | 179,740.00 |
| *Prior Preferred Stock of a Subsidiary* | 1,000,000.00 |
| *Common Stock* | 9,810,000.00 |
| *Surplus* | 3,852,053.00 |

The capitalization of another important American concern was reported recently as follows:

| | |
|---|---|
| *Common Stock* | $60,998,000.00 |
| *Preferred Stock* | 50,000,000.00 |
| *Funded Debt* | 47,591,400.00 |

The issuance of shares of stock varies somewhat with circumstances. In a small company the secretary may act as transfer agent; hence it is his duty to supervise the original issue of shares of stock. Large corporations appoint a trust company to act as transfer agent, although there are exceptions to this rule. Also it is customary to appoint a registrar, whose duty it is to see that the amount authorized is not exceeded by the amount issued. The authority of the board of directors is necessary for the appointment of both of these agents. Sometimes, but not usually, the duty of registrar and transfer agent are performed by the same trust company.

**Capital Stock Classified.** Capital stock may be classified and described in various ways. For present purposes, the following outline will be followed:

1. Common
2. Preferred
   *a*) Cumulative
   *b*) Non-cumulative
   *c*) Participating
   *d*) Non-participating
3. Redeemable
4. Voting
5. Guaranteed

When there is but one kind of stock, it is customary to regard it as common stock. The word *common*, however, has more significance when it is used in connection with the word *preferred*. This is because common stock and preferred stock are the two most common classes of stock issued by American companies and because the preferred stock is made to differ from the common stock by one or more preferences, such as a preference as to dividends, or a preference as to assets, or both. Sometimes voting rights are given to one class of stock and not to another class. Since the introduction of no-par value stock, a preference as to dividends is sometimes given to other than preferred stock. Thus there might be two classes of common stock, namely, A and B, the A stock possessing certain privileges with reference to dividends which render it the equivalent of preferred stock.

Sometimes preferred stock is cumulative. This means that if profits are not available for the payment of a dividend in a given year, this dividend must be made up when profits of following years permit. Preferred stock is cumulative unless specified to the contrary. Preferred dividends in arrears do not bear interest unless it is specifically so provided. Sometimes there is a provision to the effect that after a period of years, preferred stock which has been noncumulative becomes cumulative. This arrangement enables the company to become well established before the cumulative provision becomes effective.

Participating preferred stock shares equally with the common stock after the preferred dividend has been paid. To illustrate, assume that Company X has outstanding 6 per cent participating preferred stock amounting to $100,000.00. It also has outstanding $100,000.00 of common stock. Assuming that there is available for dividends surplus amounting to $15,000.00, this would be distributed as follows:

| | |
|---|---|
| *6 Per Cent Preferred Dividend* | *6,000.00* |
| *4½ Per Cent Common Dividend* | *4,500.00* |
| *4½ Per Cent Participating Dividend or Preferred Stock* | *4,500.00* |
| | *15,000.00* |

The redemption privilege sometimes attaches to preferred stock. This may be permitted by the law of the state but in the absence of

such legislation there is no reason why a corporation cannot make its preferred stock redeemable. This should be provided for in the charter of the corporation. The power of a corporation to redeem its preferred stock is likely to prevent the stock from going much above its redemption value on the market because investors hesitate to pay more for the stock than may be returned to them should the company decide to exercise the redemption privilege. Whether stock, once redeemed, may be reissued depends upon statutes and charter provisions. Some corporations follow the policy of setting aside a sinking fund to redeem preferred stock. When this is done the amount set aside is usually dependent upon earnings.

Common stock possesses the voting privilege unless it is specifically denied. By law it is now customary to give each share one vote, although formerly each shareholder possessed but one vote, regardless of the number of shares owned. One man may control a corporation if he owns a majority of the voting stock. Preferred stock frequently is denied the voting privilege but with the proviso that it will be granted the voting privilege if the preferred stock dividend is passed.

Guaranteed stock is stock the dividend upon which is guaranteed by another company. Guaranteed stock arises usually from the desire of one company to control a smaller company of strategic value. Sometimes guaranteed stock ranks as a high-grade investment.

A description of capital stock would be incomplete without some explanation of dividends. In a sole proprietorship the owner possesses great freedom relative to the question of retaining or not retaining profits in the business. In partnerships there are naturally more restrictions relative to the withdrawal of funds because of the necessity of equitably treating each partner. It is customary, for example, where a partner draws in excess of his share to charge interest on the excess drawings. In case of corporations, ownership and management are separated since the stockholders own the business and the directors manage it. Nevertheless the directors represent the stockholders and must pursue such policies as appear to be in their interest. The board of directors possesses wide discretionary powers. It lies with the members' judgment how much of the profits shall be distributed as dividends and how much shall be

retained in the business. If the corporation is following a program of expansion, the directors will naturally follow a conservative policy in paying dividends. It may properly be said that the dividend policy of a corporation rests upon the judgment of the board of directors.

Where there are two or more classes of stock, dividend policies become matters of special interest because of the necessity of treating each class of stockholders in accordance with the contract formed by the corporation when they purchased their stock.

Usually dividends are paid in cash, but there are many exceptions to this rule. Also, dividends usually are paid quarterly, although occasionally semiannually. Sometimes dividends are paid in property, stock, or scrip. A scrip dividend takes the form of a promissory note and bears interest. The issuing company agrees to redeem it at a later date. Scrip dividends are issued when a company's cash position renders it inadvisable to pay cash dividends.

Stock dividends are paid by issuing a share of stock for a given number of outstanding shares. Thus, if a 25 per cent stock dividend is declared, one share is issued for each four shares outstanding. The only significant effect of a stock dividend is to increase the number of units representing net worth. A regular dividend is one paid each year with the expectation of continuing to pay it. Special dividends, on the other hand, are not expected to be continued but represent a distribution made because of temporarily excessive profits.

**Management.** In both sole proprietorships and partnerships, management is exercised directly by the owners. In a corporation, management is delegated to the board of directors and officers. It is impossible for the many stockholders, sometimes thousands, to take any very active part in management, except where a stockholder happens to be a director or an officer. It may be said therefore that the exercise of authority in corporations is divided among three groups of people, namely, the stockholders, the directors, and the officers. The duties of each group are distinct, however. The stockholders own the corporation but delegate practically all powers of management to the board of directors. The board of directors in turn elects the officers who attend to the supervising of the details of daily routine. Management will therefore be considered under three heads, namely: (1) stockholders, (2) directors, (3) officers.

*1. Stockholders.* As has been stated the stockholders are the owners of the corporation. As a consequence, they are interested in its management. For evident reasons, however, they cannot participate actively in management because of the infrequency of stockholders' meetings and the usually large number of the stockholders. They make their authority felt through the board of directors which they elect at the first stockholders' meeting.

The relation of a stockholder to his corporation is not the same as that of a partner to his partnership. A stockholder may, for example, sue his corporation and for ordinary business purposes he deals at arm's length with his corporation.

It is customary for stockholders to meet annually and at such other times as special meetings may be necessary. If a stockholder does not attend the meeting, he may vote by proxy, that is, he may sign an authority giving another person the right to vote whatever number of shares he owns. Frequently, this power is given to the corporation's secretary. Also, frequently, the matters to be brought before the stockholders' meetings are largely or entirely settled in advance, in which case the meetings are little more than formal affairs held in order to meet the statutory requirements.

If stockholders become dissatisfied with the management exercised by the board of directors, their only remedy is to elect a board more nearly in agreement with their desires.

Provision for the annual meeting of the stockholders may be found in the statutes, the charter, or the by-laws. If special meetings of the stockholders are held, no business can be transacted at these meetings except as specified in the notice of the meeting. The date of the annual meeting of stockholders should be set with reference to the close of the corporation's fiscal year. This makes possible a review of the year's work and enables the stockholders to take such action with respect thereto as seems necessary. The by-laws usually contain detailed provisions relative to time and place of the annual meeting. The time of the annual meeting is usually specifically provided for, but if not it must be determined by the corporation.

If there are statutory requirements relative to stockholders' meetings these must be observed. Thus, the law of one state requires that the annual meeting be held within 90 days after the end of the

corporation's fiscal year; also that a written or printed notice stating the place, day, and hour of the meeting shall be mailed by the secretary at least 10 days before the meeting. Regardless of the fact that the charter or by-laws may specify the time and place of the annual meeting, it is customary to send written notice thereof to each stockholder.

The right to vote is perhaps the most important of a stockholder's rights. Among other rights belonging to the stockholder are the right to sell or transfer his stock, to receive dividends, to inspect the corporation's books, and to share in the assets of the corporation when liquidation is necessary.

*2. Directors.* The board of directors is the managing body of the corporation and, acting as a board, they look after the affairs of the corporation in the interest of the stockholders. Within a reasonable time after election, the board of directors must assemble in order to begin conducting the corporation's affairs. One of the first duties of the board of directors is the election of officers. As individuals the directors cannot transact the corporation's business. Only when they act as a board are their acts valid. It is insufficient to secure the assent of the majority of the board of directors separately; they must act as an assembled body.

Directors are subject to a number of liabilities. They should not pay dividends out of capital, although they are not liable to creditors if they do so, acting in good faith and without negligence. If they should pay dividends out of capital, fraudulently, or as a result of gross negligence, they become personally liable to creditors. The foregoing common law rule has been changed by statute in practically all states. Thus in some states it is provided that if directors pay dividends when the corporation is insolvent or in doing so cause it to become insolvent, those assenting thereto are held liable to creditors for the debt due at the time the dividend is declared. In many states the law requires that dividends shall be paid only from profits and in some states it is further provided that profits so employed must arise from the company's business. The following is quoted from section 58 of the New York Stock Corporation law:

No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital or capital stock is impaired, nor

shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether for a reduction of the number of its shares or of its capital or capital stock, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock, as the case may be.

The board of directors is the managing body of the corporation. The directors serve as trustees or agents of the corporation and in this capacity manage the corporation's affairs for the benefit of the stockholders, whose interests they always seek to advance. The following paragraph quoted from Cook on *Corporations* sets forth clearly the powers and limitations thereon of the board of directors.

All contracts of a corporation are to be made by or under the direction of its board of directors. The board of directors make corporate contracts by a regular vote of the board; or by authorizing an agent to make them; or by allowing an agent to assume and exercise that power; or by accepting a contract or its benefits after it has been made by an unauthorized agent. And in all cases the board of directors, and not the stockholders, nor the president, secretary, treasurer, or other agent, is the original and supreme power in corporations to make corporate contracts. The stockholders, indeed, have very few functions. The board of directors have the widest of powers. All of the various acts and contracts which a corporation may enter into are entered into by and through the board of directors. The board of directors make or authorize the making of the notes, bills, mortgages, sales, deeds, liens, and contracts generally of the corporation. They appoint the agents, direct the business, and govern the policy and plans of the corporation. The directors elect the officers, and in this connection it may be added that 'at common law there is no limit to the number of offices which may be held simultaneously by the same person, provided that no one of them is incompatible with any other.' They institute, prosecute, compromise, or appeal suits at law and in equity which the corporation brings or has brought against it. But there are limitations on their powers. If the board of directors attempt to do an act or make a contract which the corporate charter does not give the corporation the power to do or enter into, then any stockholder may enjoin that act or contract. Moreover, the directors can contract and act only as a board, duly notified and assembled. The members of the board cannot agree separately and outside of the meeting and thereby bind the corporation. Nor can a minority of the board meet and bind the board. A majority must be present, and then a majority of that majority binds the corporation. A single director has no power to contract for the corporation.

*3. Officers.* The by-laws almost always contain provisions relative to the election and duties of officers. The chief executive officer of the corporation is the president. He is the presiding officer at stockholders' meetings and meetings of the board of directors, unless

there is a chairman of the board, in which case the president presides only in the latter's absence. The following provisions relating to the president are found in the by-laws of a large American corporation:

> The president shall be chosen by the Directors from their own number, for the first year, and at their first meeting after their election in each year.
>
> In the absence of the Chairman of the Board he may preside at all meetings of the Directors, and he may call any meeting of the Board of Directors. He may at his discretion attend any meeting of the Executive Committee, or any other committee of the Board, whether or not a member of such committee.
>
> All certificates of stock and all contracts and obligations of the Company shall be signed by him, except as the Board of Directors or the By-laws of the Company shall, from time to time, authorize and direct other officers permitted by law so to do, to sign such certificates of stock, contracts or obligations.
>
> He shall have general management, subject to the control of the Board of Directors, of the business of the Company, including the appointment of all officers and employees of the Company, for whose election or appointment no other provision is made in these By-laws; and shall have the power, at any time, to discharge or remove any officer or employee of the Company, subject to the action thereon of the Board of Directors, and shall perform all other duties appertaining to his office.

In addition to the president, there may be one or more vice-presidents, a treasurer, a secretary, and a controller. If there is a vice-president, he will be vested with special powers, either in the by-laws or by the board of directors. The treasurer's duty is to take care of the funds of the company. He sees that proper records of receipts and disbursements are kept. In a general way he exercises supervision over the company's accounts. He frequently is empowered to sign the company's checks. He reports to the president. The duty of the secretary is to keep the official records of the corporation. He must record all proceedings at stockholders' and directors' meetings. Consequently, he must attend all meetings of these bodies. He keeps the corporation seal and when necessary affixes the seal to important instruments. The controller may or may not be an officer, but the tendency is to dignify the controllership by making the controller an officer. He has direct charge of the accounting system. If he is not an officer, he may report to the treasurer. If he is an officer, he will report to the president.

# *Chapter* 13

# CORPORATION ACCOUNTING

**Features of Corporation Accounting.** The student beginning the study of corporation accounting should bear in mind that in so far as principles are concerned it does not differ from other accounting. Corporation accounting is to be distinguished from sole proprietorship and partnership accounting only as regards the manner in which certain procedures peculiar to corporations must be recorded. The difference occurs in connection with the treatment of net worth. As has been explained, the original contribution of the stockholders takes the form of the purchase of capital stock; whereas, in the case of sole proprietorships and partnerships, the original contribution of the proprietor or partners takes the form of credits to the proprietor's or partners' capital accounts. Whereas, in case of sole proprietorships and partnerships, the balance of the Profit and Loss account is carried to the proprietor's Capital account or to the partners' Capital accounts, in the case of the corporation the balance of the Profit and Loss account must be carried to a Surplus account. It may be said, therefore, that the Capital Stock account or accounts and the Surplus account are the distinguishing characteristics of corporation accounting.

There are bound to be variations in procedure in corporation accounting under varying conditions. Some corporations have hundreds or thousands of stockholders, whereas in the case of other corporations, the stock is closely held by a few stockholders. It is evident that whereas one or more subordinate stock ledgers would be needed to record the holdings of many stockholders, such an arrangement would be unnecessary where the capital stock is closely held.

Likewise, there will be found variations as regards the classes of capital stock issued or issuable. The situation is simplest where there is but one kind of stock outstanding. It becomes more complicated

as additional types of capital stock are issued. Sometimes, for example, preferred stock having a par value is issued in connection with common stock with no par value. Sometimes two classes of preferred stock are found. Sometimes so-called "A" and "B" stocks are issued in addition to common stock. In the following pages the fundamental principles of accounting, as they apply to the more common situations, will be explained and illustrated.

**Issuance of Capital Stock.** The issuance of capital stock, together with certain variations thereon, will be discussed under three heads, namely: (1) par value stock, (2) preferred stock, (3) no-par value stock.

1. Issue of Par Value Stock. Let us assume that the Johnson Corporation has authorized a capital stock of $100,000.00, consisting of 1,000 shares, each having a par value of $100.00

*Illustration 1.* Assuming that only the capital stock actually issued is to be entered on the books and assuming that 500 shares of stock are sold on March 1 for cash equivalent to their par value the entry to record this sale is:

| | | | |
|---|---|---|---|
| *March 1* | | | |
| *Cash* . . . . . . . . . . . . . . . . . . . . | | *50,000.00* | |
| *Capital Stock* . . . . . . . . . . . . . . . | | | *50,000.00* |
| *For sale of 500 shares of capital stock at par to the following persons:* | | | |
| *G. B. West, 300 shares* . . . . . . . . | *30,000.00* | | |
| *R. B. Cutter, 100 shares* . . . . . . . | *10,000.00* | | |
| *S. B. Landis, 75 shares* . . . . . . . | *7,500.00* | | |
| *K. N. Morgan, 25 shares* . . . . . . . | *2,500.00* | | |

Under this plan of making an entry only for the stock sold, the capital stock account appears as in Fig. 112.

**Capital Stock**

| | | |
|---|---|---|
| | *March 1* . . . . . . . . . . . . . . | *50,000.00* |

Fig. 112

Note that the correct balance in the Capital Stock account shows the par value of the stock actually sold.

*Illustration 2.* Assume the same facts as in Illustration 1, but that the capital stock is subscribed on March 1 and that payment is received on March 15. The entries would be as follows:

| | | | |
|---|---|---|---|
| | *March 1* | | |
| *Subscriptions* | | 50,000.00 | |
| *Subscribers* | | | 50,000.00 |
| *To record subscriptions to 500 shares of capital stock at par as follows:* | | | |
| *G. B. West, 300 shares* | *30,000.00* | | |
| *R. B. Cutter, 100 shares* | *10,000.00* | | |
| *S. B. Landis, 75 shares* | *7,500.00* | | |
| *K. N. Morgan, 25 shares* | *2,500.00* | | |
| | *March 15* | | |
| *Cash* | | 50,000.00 | |
| *Subscriptions* | | | 50,000.00 |
| *For payment of subscriptions to stock made on March 1.* | | | |
| | *March 15* | | |
| *Subscribers* | | 50,000.00 | |
| *Capital Stock* | | | 50,000.00 |
| *For issuance of capital stock subscribed March 1 and paid on March 15.* | | | |

*Illustration 3.* Assume the same facts as in Illustration 1, but that the entire amount of the authorized capital stock is to be set up in the ledger accounts. The entry to show this is as follows:

| | | |
|---|---|---|
| *March 1* | | |
| *Unissued Capital Stock* | 100,000.00 | |
| *Authorized Capital Stock* | | 100,000.00 |
| *For amount of stock authorized in charter, namely, 1,000 shares having a par value of 100.00 each.* | | |

Next, assume that on March 1 subscriptions are received on one-half of this stock. The entry is:

| | | | |
|---|---|---|---|
| | *March 1* | | |
| *Subscriptions* | | 50,000.00 | |
| *Unissued Capital Stock* | | | 50,000.00 |
| *For subscriptions to 500 shares of stock at par as follows:* | | | |
| *G. B. West, 300 shares* | *30,000.00* | | |
| *R. B. Cutter, 100 shares* | *10,000.00* | | |
| *S. B. Landis, 75 shares* | *7,500.00* | | |
| *K. N. Morgan, 25 shares* | *2,500.00* | | |

Assuming that the subscriptions are paid in full on March 15, the entry is:

| | | |
|---|---|---|
| *March 15* | | |
| *Cash* | 50,000.00 | |
| *Subscriptions* | | 50,000.00 |
| *For payment of subscriptions entered on March 1.* | | |

Next, the following entry should be made:

| | | |
|---|---|---|
| *Unissued Capital Stock* | *50,000.00* | |
| *Capital Stock* | | *50,000.00* |
| *For amount of stock actually issued.* | | |

The Authorized Capital Stock account now shows a credit balance of $100,000.00 and the Unissued Capital Stock account shows a debit balance of $50,000.00. On the balance sheet the facts regarding capital stock may be set forth as shown in Fig. 113.

| | | |
|---|---|---|
| *Authorized Capital Stock* | *100,000.00* | |
| Less: *Unissued Capital Stock* | *50,000.00* | |
| *Capital Stock Outstanding* | | *50,000.00* |

Fig. 113

It would be correct to show capital stock of $50,000.00 as one item on the balance sheet, but the procedure shown in Fig. 113 is preferable because it indicates not only the amount of capital stock outstanding, but also the amount authorized but not yet issued.

2. Issue of Preferred Stock. In the preceding illustrations only one kind of stock was issued. Where two or more classes of stock are issued, it becomes necessary to designate each kind by its appropriate name. The entries are the same, however, as those already shown, except that separate entries must be made for each class of stock or if the issue of two or more classes of stock is made at one time the entries made are combined in the form of compound journal entries.

To illustrate, assume that the Johnson Corporation has authorized by its charter $100,000.00 of common stock and $100,000.00 of preferred "A" stock. Assume further that $50,000.00 of each class of stock is subscribed on March 1 and paid for on March 15. Following the method illustrated above in Illustration 3, the entries on the books of the Johnson Corporation are shown below:

*March 1*

| | | |
|---|---|---|
| *Unissued Common Stock* | *100,000.00* | |
| *Unissued Preferred "A" Stock* | *100,000.00* | |
| *Authorized Common Stock* | | *100,000.00* |
| *Authorized Preferred "A" Stock* | | *100,000.00* |
| *For amount of stock authorized in charter, namely, 1,000 shares of common stock, having a par value of 100.00 each and 1,000 shares of preferred "A" stock, having a par value of 100.00 each.* | | |

Assuming that on March 1 subscriptions are received on one-half of each class of stock, the entry is:

*March 1*

| | | |
|---|---|---|
| *Subscriptions to Common Stock* | 50,000.00 | |
| *Subscriptions to Preferred "A" Stock* | 50,000.00 | |
| *Unissued Common Stock* | | 50,000.00 |
| *Unissued Preferred "A" Stock* | | 50,000.00 |

*For subscriptions to 500 shares of common stock at par and to 500 shares of preferred "A" stock as follows:*

| | |
|---|---|
| *Common* | |
| *R. T. Martin* | *200 shares* |
| *B. K. Lord* | *100 shares* |
| *R. N. Morris* | *150 shares* |
| *N. K. North* | *50 shares* |
| *Preferred "A"* | |
| *A. R. Southern* | *150 shares* |
| *B. G. Cutter* | *150 shares* |
| *N. L. East* | *150 shares* |
| *N. K. Portor* | *50 shares* |

Assuming that the subscriptions are paid in full on March 15, the entry is:

| | | |
|---|---|---|
| *Cash* | 100,000.00 | |
| *Subscriptions to Common Stock* | | 50,000.00 |
| *Subscriptions to Preferred "A" Stock* | | 50,000.00 |

*For payment of subscriptions entered on March 1.*

Next, the following entry should be made:

| | | |
|---|---|---|
| *Authorized Preferred "A" stock* | 50,000.00 | |
| *Authorized Common Stock* | 50,000.00 | |
| *Preferred "A" stock* | | 50,000.00 |
| *Common Stock* | | 50,000.00 |

*For amount of stock actually issued.*

On the balance sheet the facts relative to capital stock authorized and issued may be shown as set forth in Fig. 114.

| | | |
|---|---|---|
| *Authorized Common Stock* | 100,000.00 | |
| Less: *Unissued Common Stock* | 50,000.00 | |
| *Common Stock Outstanding* | | 50,000.00 |
| *Authorized Preferred "A" Stock* | 100,000.00 | |
| Less: *Unissued Preferred "A" Stock* | 50,000.00 | |
| *Preferred "A" Stock Outstanding* | | 50,000.00 |

Fig. 114

*Installment Sale of Capital Stock.* Frequently, capital stock is sold with the provision that the amount of the subscription is to be paid in installments. This provision makes it easier for the subscriber to

secure the required funds and enables the corporation usually to obtain money as it is needed. As a rule, the dates on which succeeding installments are due are specified in the terms of sale, but sometimes the "call" may be issued at any time. The disadvantage from the point of view of the subscriber is that a "call" may be issued at any time. The subscriber is given a receipt for each installment paid, and upon the payment of the final installment and the surrender of his receipts the subscriber receives his stock certificate.

*Illustration 1.* Assume that A. K. Jones subscribes for 50 shares of the common stock of the McArthur Company at par on August 1. Installments are to be paid as follows: 25 per cent at time of subscription; 25 per cent on September 1; 25 per cent on October 1; 25 per cent on November 1.

Following the plan used in Illustration 3, above, the entries are shown below:

| | | |
|---|---|---|
| *Subscriptions to Common Stock* | *5,000.00* | |
| *Unissued Common Stock* | | *5,000.00* |
| *For subscription of A. K. Jones to 50 shares of common stock at par.* | | |
| *August 1* | | |
| *Cash* | *1,250.00* | |
| *Subscriptions to Common Stock* | | *1,250.00* |
| *For payment of 25 per cent by A. K. Jones on stock subscription.* | | |
| *August 15* | | |
| *Call Number 1* | *1,250.00* | |
| *Subscriptions to Common Stock* | | *1,250.00* |
| *For issuance of Call Number 1 to A. K. Jones for 25 per cent of his subscription.* | | |
| *September 1* | | |
| *Cash* | *1,250.00* | |
| *Call Number 1* | | *1,250.00* |
| *For payment of Call Number 1.* | | |
| *September 15* | | |
| *Call Number 2* | *1,250.00* | |
| *Subscription to Common Stock* | | *1,250.00* |
| *For issuance of Call Number 2 to A. K. Jones.* | | |
| *October 1* | | |
| *Cash* | *1,250.00* | |
| *Call Number 2* | | *1,250.00* |
| *For payment of Call Number 2.* | | |
| *October 15* | | |
| *Call Number 3* | *1,250.00* | |
| *Subscriptions to Common Stock* | | *1,250.00* |
| *For issuance of Call Number 3 to A. K. Jones.* | | |

| | | | |
|---|---|---|---|
| | *November 1* | | |
| *Cash* | | *1,250.00* | |
| *Call Number 3* | | | *1,250.00* |
| *For payment of Call Number 3.* | | | |
| | *November 1* | | |
| *Authorized Capital Stock* | | *5,000.00* | |
| *Capital Stock* | | | *5,000.00* |
| *For stock issued to A. K. Jones.* | | | |

*Discount on Stock.* Many of the states prohibit the sale of capital stock at a discount, on the theory that the par value of the stock represents a kind of trust fund which should be held inviolable for the benefit of the creditors of the corporation. Obviously, when capital stock is issued for assets other than cash, there exists the possibility that these assets may be overvalued, thus resulting in a situation equivalent to the issuing of capital stock at a discount. It is a universal requirement that capital stock having a par value shall be shown on the books at its par value, not at a sum greater or less than par value. In a few instances the state corporation laws permit the sale of par value capital stock at a discount.

It is evident that when capital stock is sold at a discount, the par value of the capital stock does not reflect the true amount of net worth resulting from such sale. If, for example, a share of stock having a par value of \$100.00 is sold for \$90.00, the contribution to net worth is \$90.00; therefore the discount of \$10.00 represents a sum which should be deducted on the balance sheet from the par value of the stock. Assume that a corporation has issued a total of \$100,000.00 of par value capital stock at a discount of 10 per cent, or \$10,000.00. The facts should be expressed on the balance sheet as shown in Fig. 115.

| | | |
|---|---|---|
| *Capital Stock (par value).* | *100,000.00* | |
| Less *discount* | *10,000.00* | *90,000.00* |

Fig. 115

Even though the stock of a corporation may be issued regularly at a discount, the stockholder may still be held liable to creditors in the event of the insolvency of the corporation.

*Illustration 1.* Assume that the Barnes Company sells \$50,000.00 of capital stock at a discount of 5 per cent. The entry at the time of sale is as follows:

| | | |
|---|---|---|
| *Cash* | *47,500.00* | |
| *Discount on Capital Stock* | *2,500.00* | |
| *Capital Stock* | | *50,000.00* |
| *For sale of capital stock, par value 50,000.00 at a discount of 5 per cent.* | | |

Theoretically this discount of $2,500.00 should remain permanently on the books in order to make clear the fact that the capital stock, having a par value of $50,000.00, was sold for $47,500.00. In case of prosperous corporations, there is a tendency to cancel the Discount account against Surplus, apparently on the theory that the Discount account reflects an unfavorable financial situation. It is believed that when the true meaning of discount is better understood, this tendency will disappear and that the Discount account will be regarded as a Valuation account to be related to the Capital Stock account and to be deducted on the balance sheet from the par value of capital stock outstanding.

*Premium on Capital Stock.* There is no legal restriction against capital stock issued at a premium. Although the amount of the premium is usually credited to a premium on Capital Stock account, this is, in reality, a division of capital surplus and should be so indicated.

*Illustration 1.* Assume that the Apex Corporation issues $50,000.00 par value of capital stock at a premium of 5 per cent. If sold for cash the entry is as follows:

| | | |
|---|---|---|
| *Cash* | *52,500.00* | |
| *Capital Stock* | | *50,000.00* |
| *Premium on Capital Stock* | | *2,500.00* |
| *For sale of 50,000.00 of capital stock at a premium of 5 per cent.* | | |

Sometimes the Premium on Capital Stock account is closed into Surplus, but the preferable procedure is to carry it permanently in the Premium on Capital Stock account. On the balance sheet the showing of premium on capital stock is as illustrated in Fig. 116.

| | | |
|---|---|---|
| *Capital Stock* | *50,000.00* | |
| Add: *Premium on Capital Stock* | *2,500.00* | *52,500.00* |

Fig. 116

**Complete Illustration.** In order to illustrate the various principles discussed in preceding pages, an illustration will be given in which the steps are combined and status of the ledger accounts shown.

Assume that the Western Company has authorized in its charter $100,000.00 of common stock and $50,000.00 of 6 per cent preferred stock. The $50,000.00 of the common stock is subscribed for on January 15 at a discount of 5 per cent and is paid for in three installments as follows:

| | |
|---|---|
| *February 15* | *30.00 per share* |
| *March 15* | *30.00 per share* |
| *April 15* | *35.00 per share* |

The entire amount of the preferred stock is subscribed for at a premium of 10 per cent and is paid in two installments, as follows:

| | |
|---|---|
| *February 15* | *50.00 per share* |
| *March 15* | *60.00 per share* |

The entries to record these transactions are shown below. Following the entries are the ledger accounts which result as they appear after all entries are posted.

| | | |
|---|---|---|
| *January 15* | | |
| *Unissued Common Stock* | *100,000.00* | |
| *Unissued Preferred Stock* | *50,000.00* | |
| *Authorized Common Stock* | | *100,000.00* |
| *Authorized Preferred Stock* | | *50,000.00* |
| *For stock authorized in charter.* | | |
| *January 15* | | |
| *Subscriptions to Common Stock* | *47,500.00* | |
| *Subscriptions to Preferred Stock* | *55,000.00* | |
| *Discount on Common Stock* | *2,500.00* | |
| *Premium on Preferred Stock* | | *5,000.00* |
| *Unissued Common Stock* | | *50,000.00* |
| *Unissued Preferred Stock* | | *50,000.00* |
| *For subscription.* | | |
| *February 1* | | |
| *Call No. 1 (Common)* | *15,000.00* | |
| *Subscriptions to Common Stock* | | *15,000.00* |
| *Call No. 1 (Preferred)* | *25,000.00* | |
| *Subscriptions to Preferred Stock* | | *25,000.00* |
| *February 15* | | |
| *Cash* | *15,000.00* | |
| *Call No. 1 (Common)* | | *15,000.00* |
| *Cash* | *25,000.00* | |
| *Call No. 1 (Preferred)* | | *25,000.00* |
| *March 1* | | |
| *Call No. 2 (Common)* | *15,000.00* | |
| *Subscriptions to Common Stock* | | *15,000.00* |
| *Call No. 2 (Preferred)* | *30,000.00* | |
| *Subscriptions to Preferred Stock* | | *30,000.00* |

*March 15*

| | | |
|---|---|---|
| Cash | 15,000.00 | |
| Call No. 2 (Common) | | 15,000.00 |
| Cash | 30,000.00 | |
| Call No. 2 (Preferred) | | 30,000.00 |

*March 15*

| | | |
|---|---|---|
| Authorized Preferred Stock | 50,000.00 | |
| Preferred Stock | | 50,000.00 |

*April 1*

| | | |
|---|---|---|
| Call No. 3 (Common) | 17,500.00 | |
| Subscription to Common Stock | | 17,500.00 |

*April 15*

| | | |
|---|---|---|
| Cash | 17,500.00 | |
| Call No. 3 (Common) | | 17,500.00 |

*April 15*

| | | |
|---|---|---|
| Authorized Common Stock | 50,000.00 | |
| Common Stock | | 50,000.00 |

**Unissued Common Stock**

| | | | | | |
|---|---|---|---|---|---|
| Jan. 15 | Authorized | 100,000.00 | Jan. 15 | Subscriptions | 50,000.00 |

**Unissued Preferred Stock**

| | | | | | |
|---|---|---|---|---|---|
| Jan. 15 | Authorized | 50,000.00 | Jan. 15 | Subscriptions | 50,000.00 |

**Authorized Common Stock**

| | | | | | |
|---|---|---|---|---|---|
| Apr. 15 | Common | 50,000.00 | Jan. 15 | | 100,000.00 |

**Authorized Preferred Stock**

| | | | | | |
|---|---|---|---|---|---|
| Mar. 15 | Preferred | 50,000.00 | Jan. 15 | | 50,000.00 |

**Subscriptions to Common Stock**

| | | | | | |
|---|---|---|---|---|---|
| Jan. 15 | Unissued | 47,500.00 | Feb. 1 | Call No. 1 | 15,000.00 |
| | | | Mar. 1 | Call No. 2 | 15,000.00 |
| | | | Apr. 1 | Call No. 3 | 17,500.00 |

**Subscriptions to Preferred Stock**

| | | | | | |
|---|---|---|---|---|---|
| Jan. 15 | Unissued | 55,000.00 | Feb. 1 | Call No. 1 | 25,000.00 |
| | | | Mar. 1 | Call No. 2 | 30,000.00 |

**Discount on Common Stock**

| | | | | | |
|---|---|---|---|---|---|
| *Jan. 15* | *Unissued* | *2,500.00* | | | |

**Premium on Preferred Stock**

| | | | | | |
|---|---|---|---|---|---|
| | | | *Jan. 15* | *Subscriptions* | *5,000.00* |

**Call No. 1 (Common)**

| | | | | | |
|---|---|---|---|---|---|
| *Feb. 1* | *Subscriptions* | *15,000.00* | *Feb. 15* | *Cash* | *15,000.00* |

**Call No. 1 (Preferred)**

| | | | | | |
|---|---|---|---|---|---|
| *Feb. 1* | *Subscriptions* | *25,000.00* | *Feb. 15* | *Cash* | *25,000.00* |

**Cash**

| | | | | | |
|---|---|---|---|---|---|
| *Feb. 15* | *Call No. 1 (Common)* | *15,000.00* | | | |
| *Feb. 15* | *Call No. 1 (Preferred)* | *25,000.00* | | | |
| *Mar. 15* | *Call No. 2 (Common)* | *15,000.00* | | | |
| *Mar. 15* | *Call No. 2 (Preferred)* | *30,000.00* | | | |
| *Apr. 15* | *Call No. 3 (Common)* | *17,500.00* | | | |

**Call No. 2 (Common)**

| | | | | | |
|---|---|---|---|---|---|
| *Mar. 1* | *Subscriptions* | *15,000.00* | *Mar. 15* | *Cash* | *15,000.00* |

**Call No. 2 (Preferred)**

| | | | | | |
|---|---|---|---|---|---|
| *Mar. 1* | | *30,000.00* | *Mar. 15* | *Cash* | *30,000.00* |

**Call No. 3 (Common)**

| | | | | | |
|---|---|---|---|---|---|
| *Apr. 1* | *Subscriptions* | *17,500.00* | *Apr. 15* | *Cash* | *17,500.00* |

**Common Stock**

| | | | | | |
|---|---|---|---|---|---|
| | | | *Apr. 15* | | *50,000.00* |

**Preferred Stock**

| | | | | | |
|---|---|---|---|---|---|
| | | | *Mar. 15* | | *50,000.00* |

**3. Capital Stock of No Par Value.** Since no-par-value stock by its very nature has no fixed value as does par value stock, it is impossible to make an entry debiting Unissued Capital Stock and crediting Capital Stock Authorized. Also there can be no premium or discount involved in connection with the sale of no-par stock. It is simply necessary to credit the Capital Stock account with the amount of the subscription. When payment is made, Cash is debited and Subscriptions account is credited.

*Illustration 1.* Assume that the Ironton Company incorporates with an authorized capital stock of 50,000 shares of no-par-value stock on March 25. Subscriptions are received to 25,000 shares of this stock at $15.00 per share.

| | | |
|---|---|---|
| *Subscriptions* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *375,000.00* | |
| *No-Par Value Common Stock* . . . . . . . . . . . . . . . . . . . . . . | | *375,000.00* |
| *For subscriptions to 25,000 shares of stock at 15.00 per share.* | | |

If payment is received on March 30, the entry is as follows:

| | | |
|---|---|---|
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *375,000.00* | |
| *Subscriptions* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *375,000.00* |
| *For payment in full of subscriptions entered on March 25.* | | |

Assume next that 10,000 additional shares are subscribed for at $20.00 per share on July 1 and paid for on July 10. The entries are as follows:

| | | |
|---|---|---|
| *Subscriptions* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *200,000.00* | |
| *No-Par Common Stock* . . . . . . . . . . . . . . . . . . . . . . . . . . | | *200,000.00* |
| *For subscriptions to 10,000 shares at 20.00 per share.* | | |
| *July 10* | | |
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *200,000.00* | |
| *Subscriptions* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *200,000.00* |
| *For payment in full of subscriptions to 10,000 shares at 20.00 per share.* | | |

The facts relative to the no-par common stock of the Ironton Company are shown on the balance sheet as at July 31, as illustrated in Fig. 117.

| | | |
|---|---|---|
| *Authorized No-Par Stock* . . . . . . . . . . . . . . . . . . . . . . . . . . . | *50,000 shares* | |
| Less *Unissued* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *15,000* | |
| *Issued* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *35,000 shares* | *575,000.00* |

Fig. 117

**Incorporation Procedure.** It may be desirable to incorporate sole proprietorships and partnerships under certain conditions. For example, the feature of limited liability may appeal to these types of organization. Also it may be desirable to incorporate because of advantages which may be secured in organization and management. Sometimes additional funds can be secured only by first incorporating, thus making it possible to appeal to a larger number of investors. The procedure to incorporate is not essentially different from that which is followed by a new enterprise. An application for a charter must be accepted by the secretary of state. The proprietor or partners accept capital stock in lieu of their interest in the previously unincorporated enterprise.

*Illustration 1.* Assume that John Smith is a sole proprietor engaged in the hardware business. He decides to incorporate under the name of John Smith Company. The authorized capital stock of this company is $50,000.00, consisting of 500 shares of a par value of $100.00 each. The date of incorporation is July 1, 19–7 and the balance sheet of John Smith, Sole Proprietor, as at June 30, 19–7 is as shown in Fig. 118.

**John Smith**

BALANCE SHEET

**as at June 30, 19–7**

| *Assets* | | *Liabilities* | |
|---|---|---|---|
| Cash | $ 2,000.00 | Notes Payable | $ 6,000.00 |
| Merchandise | 20,000.00 | Accounts Payable | 10,000.00 |
| Accounts Receivable | 12,000.00 | Mortgage | 6,000.00 |
| Notes Receivable | 5,000.00 | | |
| Building | 13,000.00 | *Net Worth* | |
| Land | 3,000.00 | John Smith, Capital | 36,000.00 |
| Furniture and Fixtures | 2,000.00 | | |
| Delivery Equipment | 1,000.00 | | |
| | $58,000.00 | | $58,000.00 |

Fig. 118

Entries on John Smith Company, Inc., books:

*July 1, 19–7*

| | | |
|---|---|---|
| *Subscriptions* | *36,000.00* | |
| *Capital Stock* | | *36,000.00* |
| *To record Subscriptions to Capital Stock by John Smith.* | | |

*July 1, 19–7*

| | | |
|---|---|---|
| *Cash* | 2,000.00 | |
| *Merchandise* | 20,000.00 | |
| *Accounts Receivable* | 12,000.00 | |
| *Notes Receivable* | 5,000.00 | |
| *Building* | 13,000.00 | |
| *Land* | 3,000.00 | |
| *Furniture and Fixtures* | 2 000.00 | |
| *Delivery Equipment* | 1,000.00 | |
| *Notes Payable* | | 6,000.00 |
| *Accounts Payable* | | 10,000.00 |
| *Mortgage* | | 6,000.00 |
| *John Smith, Vendor* | | 36,000.00 |
| *To purchase assets and assume debts of John Smith.* | | |

*July 1, 19–7*

| | | |
|---|---|---|
| *John Smith, Vendor* | 36,000.00 | |
| *Subscriptions* | | 36,000.00 |
| *To settle John Smith's subscriptions.* | | |

Closing entries on John Smith's books:

*July 1, 19–7*

| | | |
|---|---|---|
| *Stock of John Smith Company* | 36,000.00 | |
| *Notes Payable* | 6,000.00 | |
| *Accounts Payable* | 10,000.00 | |
| *Mortgage* | 6,000.00 | |
| *Cash* | | 2,000.00 |
| *Merchandise* | | 20,000.00 |
| *Accounts Receivable* | | 12,000.00 |
| *Notes Receivable* | | 5,000.00 |
| *Building* | | 13,000.00 |
| *Land* | | 3,000.00 |
| *Furniture and Fixtures* | | 2,000.00 |
| *Delivery Equipment* | | 1,000.00 |
| *To transfer assets and debts of John Smith to John Smith Company.* | | |

*July 1, 19–7*

| | | |
|---|---|---|
| *John Smith, Capital* | 36,000.00 | |
| *Stock of John Smith Company* | | 36,000.00 |
| *To close books by transferring stock of John Smith Company to John Smith.* | | |

**Records Peculiar to Corporation Accounting.** In general, the accounting records of a corporation do not differ from those of a sole proprietorship or partnership. Of course, the greater size of some corporations makes necessary the subdivision of subordinate ledgers to a greater extent than is required in unincorporated enterprises; however, in connection with the issuance of capital stock certifi-

cates, it is necessary to employ certain records peculiarly adapted to the purpose. Below is given a brief discussion of such records.

1. *Subscriptions Journal.* The entry in the Subscriptions Journal is made from the subscriptions blank which the subscriber signs and whereby he agrees to accept and pay for a certain amount of capital stock. A form of subscriptions journal is shown in Fig. 119.

**Subscriptions Journal**

| Date | | Name and Address of Subscriber | No. Shares | S. L. F | Amount |
|---|---|---|---|---|---|
| | | | | | |

Fig. 119

2. *Subscriptions Ledger.* If the subscriptions are numerous, it is desirable to employ a Subscriptions Ledger controlled by the Subscriptions account in the general ledger. Postings are made from the subscriptions journal to the subscriptions ledger and, of course, totals are carried to the controlling Subscriptions account in the general ledger. A form of subscriptions ledger is shown in Fig. 120.

**Subscriptions Ledger**

Subscriber's Name________________________________________

Address______________________________________________

| Date | | No. Shares | Amount | F | Call Number | Amount | Date Due | Date Paid |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

Fig. 120

3. *Stock Certificate Book.* The Stock Certificate Book contains blank stock certificates attached to stubs. A stock certificate is made out in the name of the stockholder and for whatever number of shares he has paid for in full. On the stub of the stock certificate are

spaces designed to contain the essential information shown on the certificate itself, such as the stockholder's name, the serial number of the certificate, the date, and the number of shares represented by the certificate.

*4. Stockholders' Ledger.* The Stockholders' Ledger is controlled by the Capital Stock account in the general ledger. A separate account is carried in the stockholders' ledger for each stockholder. In this account is shown the essentials relative to the stockholder's ownership of stock. This information is posted from the stubs of the stock certificate book. One form of stockholders' ledger is illustrated in Fig. 121.

**Stockholders' Ledger**

| When Stock Issued 19— | Certificate No. | | Stock Register Page | No. of Shares of Stock | DEBIT |
|---|---|---|---|---|---|
| | Old | New | | | To par value of stock |
| | | | | | |

**Stockholders' Ledger**—*Continued*

| CREDITS | | Date of Transfer | | | No. in Transfer Record | Surrendered Certificates | |
|---|---|---|---|---|---|---|---|
| By Cash, Mdse. and Notes | By Amt. of Dividends | Month | Day | Year | | Number | No. of Shares |
| | | | | | | | |

Fig. 121

*5. Stock Transfer Book.* Where stock is actively transferred from one stockholder to another, it is necessary to keep a Stock Transfer Book. From this book entries are posted to the stockholders' ledger. Transfers of stock have no effect on the total amount of outstanding stock and therefore have no effect on the Capital Stock controlling account. A form of stock transfer book is illustrated in Fig. 122 on the following page.

**Transfer Book**

Transfer Record of the........................................................

| Surrendered | | | Re-issued | |
|---|---|---|---|---|
| No. of Certificate | No. of Shares | Transfer No ...Entered on Stock Register Page..... | No. of Certificate | No. of Shares |
| ......... | ...... | | ......... | ....... |
| ........ | ...... | | ....... | ...... |
| ....... | ...... | | ........ | ....... |
| ......... | ...... | | ........ | ....... |

For Value Received, ........................ hereby surrender Certificate No.. .. for ......... shares of the capital stock of the above corporation, and .. .... . hereby authorize the cancellation of said Certificate and the issue of new Certificate therefor to the following persons:

..................................................

..................................................

..................................................

..................................................

..................................................

Date............................

Signed.............................(Seal)

Fig. 122

# *Chapter* 14

# CORPORATION ACCOUNTING

(*Continued*)

**Nature of Surplus.** The Surplus account is a distinctive feature of corporation accounting. Too often, however, it is thought of as an item of relatively simple character. In reality, surplus may be derived from various sources and used in various ways. In a sense, the Surplus account is a balancing figure, since it is the sum of the assets less liabilities and capital stock.

It is evident that at the commencement of operations there can be no surplus if the capital stock is sold for its par value. It is equally evident, however, that the situation soon changes as a result of profits and losses made in operations. The three principal divisions of surplus are: (*a*) earned, (*b*) capital, (*c*) paid-in.

*a*) *Earned Surplus.* Earned surplus is that which is derived from profits, whether operating or nonoperating. Naturally, the most frequent source of earned surplus is operating profit, and it is from this source that most of the surplus accumulations may be expected to be derived. In the sole proprietorship the operating profit is carried directly to the proprietor's Capital account. In a partnership the net profit, after being divided in accordance with the partnership agreement, is transferred to the drawings accounts of the partners, which are in turn closed out into the partners' Net Worth accounts. In a corporation the capital stock remains unchanged after it has once been issued. This is true even in the case of no par value stock which continues to be carried at the issuance price. Par value stock is, of course, carried at its par value. As a consequence, the net profit cannot be carried from the Profit and Loss account to the Capital Stock account; instead, the net profit (or loss) is carried to a Surplus account. This may properly be entitled Earned Surplus account to distinguish it from surplus which may be derived from other sources.

*b*) *Capital Surplus.* Fundamentally there are but two kinds of

surplus, namely, earned surplus and capital surplus. For convenience, however, a third division of surplus coordinate with earned surplus and capital surplus is given frequently. This is paid-in surplus. Capital surplus represents all increments in value other than those which reflect operating or nonoperating profit, with the possible exception of so-called paid-in surplus which originates when capital stock is sold. It is the fact that paid-in surplus arises in a somewhat unique manner that justifies showing it as a separate division of surplus coordinate with earned surplus and capital surplus.

Accountants are not entirely agreed as to the distinction between earned surplus and capital surplus. It is believed, however, that wherever profit is actually realized through a sale it is well to regard such profit as an addition to earned surplus. Where on the other hand the gain is merely potential in character, such as that resulting from the estimated increase in value of land, such increase being entered on the books, the increment should be regarded as capital surplus. It is unnecessary to attempt at this point to indicate all of the sources of capital surplus. The distinction already made between earned surplus and capital surplus should aid in determining which kind of surplus arises in a given situation.

*c) Paid-in Surplus.* Paid-in surplus results from the payment by stockholders of sums in excess of the par value of capital stock. For example, if the X Company sells $100,000.00 of par value capital stock at a premium of 10 per cent, the entry for the sale is as follows:

| | | |
|---|---|---|
| *Cash* | *110,000.00* | |
| *Capital Stock* | | *100,000.00* |
| *Paid-in Surplus (or Premium on Capital Stock)* | | *10,000.00* |
| *For sale of capital stock at a premium of 10 per cent.* | | |

In case of no-par value stock the entire sales price is credited to the Capital Stock account; hence no premium would arise even though the stock sold for $110.00 per share. The entry in such case would be as follows:

| | | |
|---|---|---|
| *Cash* | *110,000.00* | |
| *No-Par Value Capital Stock* | | *110,000.00* |
| *For sale of 1,000 shares of no-par value stock at 110.00.* | | |

Banks frequently have a large paid-in surplus, but it is the exception rather than the rule for industrial corporations to carry

such an account on the balance sheet. Where capital stock sells at a discount the effect is exactly the opposite from the one resulting from the sale of capital stock at a premium; whereas the premium results in an increase in net worth, a discount results in a decrease in net worth. The two items may be permitted to offset each other, the balance representing either an addition to or a deduction from capital stock. To illustrate, assume that Corporation B sells $50,000.00 par value of capital stock at a discount of 5 per cent and that later it sells $50,000.00 additional stock at a premium of 10 per cent. The Paid-in Surplus account, which reflects premium and discount, then appears as shown in Fig. 123.

**Paid-In Surplus**

| | | | |
|---|---|---|---|
| *Capital Stock* | *2,500.00* | *Cash* | *5,000.00* |

Fig. 123

**Uses of Surplus.** Crediting the Earned Surplus account with realized profits indicates that there exists a corresponding increase on the asset side of the balance sheet. It is only natural to infer that such assets are being profitably employed. Therefore the creation of surplus means that the assets have increased and that automatically benefits result. It may be said, therefore, that one of the principal uses of surplus is its retention in the business without being set aside in the form of any specific asset. Where the Surplus account shows only credit items, it is reasonable to assume that this surplus has all been retained in the business. Where there are debit items in the Surplus account it means either (*a*) that some of the surplus has been distributed to stockholders in the form of dividends, or (*b*) that it has been segregated as one or more reserves, or (*c*) that losses of an extraordinary character and possibly adjustments in asset values have been charged to the Surplus account. In case of (*a*) and (*c*) the surplus is reduced. In case of (*b*) a portion of the surplus is simply transferred to another account.

To illustrate the procedure indicated above, assume that in 19— Corporation X carries $100,000.00, representing net profit, to its Earned Surplus account. Assume that in 19— an extraordinary fire loss, amounting to $10,000.00, is charged to the Earned

Surplus account, that $20,000.00 is set aside out of surplus as a reserve for betterments, and that a cash dividend amounting to $50,000.00 is paid. The Surplus account at the end of 19— appears as shown in Fig. 124.

**Earned Surplus**

| | | | | | |
|---|---|---|---|---|---|
| *19—* | *Fire Loss* | *10 000.00* | *19—* | *Profit and Loss* . | *100,000 00* |
| | *Res. Betterments* | *20,000 00* | *19—* | *Profit and Loss* | *150,000.00* |
| | *Dividend Payable* | *50,000.00* | | | |

**Reserve for Betterments**

| | | | | | |
|---|---|---|---|---|---|
| | | | *19—* | *Earned Surplus.....* | *20,000.00* |

Fig. 124

An examination of the Earned Surplus account shown in Fig. 124 will indicate how earned surplus is created and how it is employed. The sum of $250,000.00 has been transferred from the Profit and Loss account to the Earned Surplus account. This is the amount of earned surplus, created over a two-year period. Of this amount there remains in the business in the form of free earned surplus $170,000.00. In addition there remains in the business $20,000.00 which has been earmarked as a reserve for betterments, as shown in Fig. 124. The sum of $60,000.00 of earned surplus has disappeared. Of this amount $10,000.00 has been used to cover a fire loss and $50,000.00 has been disbursed to stockholders as dividends.

The student should consider the preceding illustration of earned surplus and, in order to secure an understanding of its true character, note how it originates, how it may be retained in the business, or how it may be reduced through changes covering extraordinary losses and dividends.

**Free Surplus.** It is desirable, first, to consider the meaning of what is commonly termed *free* surplus. It is simply the credit balance in the Earned Surplus account. For example, in Fig. 124 the earned surplus is $170,000.00. Being free surplus, it is available for practically any use to which surplus may be put, but there are limitations on these uses. Among the uses of free surplus are the following: (1) declare dividends, (2) establish reserves of surplus, (3) absorb losses, (4) remain as free surplus.

Free surplus may therefore be regarded as a reservoir which may be drawn on for certain purposes. Regardless of the condition of the assets, transfers may be made from free surplus to reserve accounts and extraordinary losses may be charged against free surplus; however, dividends can be declared and paid only if there is on hand sufficient cash, and the mere existence of free surplus is no guaranty that there is an equivalent amount of cash available. This is a matter of management; and if a corporation desires to pursue a certain dividend policy, it must exercise foresight in the expenditure of cash in order to have available the amount of cash which may be required for the payment of dividends.

**Surplus Reserves.** The reservation of earned surplus in the form of so-called reserves is a matter deserving careful consideration, although the setting aside of earned surplus in the form of a large number of surplus reserves is usually to be deprecated. The establishment of certain important surplus reserves is usually an indication of conservatism on the part of management. Of course, there may be no contract requiring the establishment of a particular reserve, in which event the board of directors may, if they see fit, reverse their policy and transfer the amount in a given surplus reserve account back to free surplus. In some instances, however, the procedure may be contractual in character, as is usually the case when sinking fund reserves are set up. When this is the case, the board of directors cannot alter the provisions of the trust deed or other instrument which specifies how the reserve is to be treated.

Surplus reserves will be explained and illustrated under the following heads: (*a*) contingencies, (*b*) sinking funds, (*c*) betterments.

*a*) *Contingencies.* If present circumstances indicate that in the future a certain development *may* occur, such development is termed a contingency. Contingencies are of many kinds, but interest here centers in contingent losses. If Company Y is being sued for an alleged infringement on a patent, it is evident that there may be a contingent loss because of the possibility of an adverse decision. If Company G is suing Company Y for $100,000.00, this represents a contingent liability which becomes an actual liability in case of an unfavorable judgment. Of course, the amount of the liability may be reduced below $100,000.00. Free surplus may be made to serve

as a protection against contingent losses, owing to the fact that free surplus may at any time be employed to pay a dividend. The board of directors may deem it advisable to set up what is known as a reserve for contingencies. If the board authorizes the accounting department to do this, the entry is as follows:

| | | |
|---|---|---|
| *Earned Surplus* | *100,000.00* | |
| *Reserve for Contingencies* | | *100,000.00* |
| *To set aside earned surplus as a protection against possible adverse court decisions.* | | |

Should the decision of the court direct the payment by Company Y to Corporation G of $75,000.00, the entry should be:

| | | |
|---|---|---|
| *Reserve for Contingencies* | *75,000.00* | |
| *Cash* | | *75,000.00* |
| *For payment of court judgment in favor of Corporation G.* | | |

There now remains in the Reserve for Contingencies account a credit balance of $25,000.00, and since the contingency in connection with which the reserve is set up no longer exists, this balance may be transferred back to Earned Surplus through the following entry:

| | | |
|---|---|---|
| *Reserve for Contingencies* | *25,000.00* | |
| *Earned Surplus* | | *25,000.00* |
| *To close balance of Reserve for Contingencies account to Earned Surplus account.* | | |

There are, of course, many possible contingencies and it may be desirable to set up a reserve for contingencies generally. If this is done the Contingencies account will not be closed back into surplus but it will remain on the books and be charged with whatever unusual or extraordinary losses may occur.

Not infrequently a contingency arises in connection with the discounting of notes, since indorsement of a note constitutes a contingent liability. Also contingencies arise in the form of accommodation indorsements.

*b) Sinking Funds.* Whereas reserves for contingencies are optional with the corporation, sinking fund reserves are rarely found except when specifically required under the terms of the trust deed relating to a bond issue. Sometimes the trust deed specifies the establishment of a sinking fund but makes no provision for a sinking fund reserve;

sometimes both are required. An illustration will show the procedure followed where both fund and reserve are required.

Assume that Corporation O has issued bonds amounting to $100,000.00 and having a maturity date 10 years hence. The trust deed requires the payment each year into a sinking fund of $10,000.00 to be used for the redemption of outstanding bonds as the judgment of the sinking fund trustee dictates. The trust deed also requires the establishment of a sinking fund reserve out of surplus by transferring, at the end of each of the 10 years, of $10,000.00 from earned surplus to the Sinking Fund Reserve account. The entry each year for the payment of $10,000.00 into the sinking fund is as follows:

| | | |
|---|---|---|
| *Sinking Fund* | *10,000.00* | |
| *Cash* | | *10,000.00* |
| *For annual payment to sinking fund as required in trust deed.* | | |

The entry each year to carry $10,000.00 from Earned Surplus to the Sinking Fund Reserve account is:

| | | |
|---|---|---|
| *Surplus* | *10,000.00* | |
| *Sinking Fund Reserve* | | *10,000.00* |
| *For yearly addition to Sinking Fund Reserve account as required in trust deed.* | | |

At the end of ten years there is $100,000.00 in the sinking fund, assuming that the interest earned by the fund is not added to the fund. This fund now is used to pay off the bond issue and the entry for the payment is as follows:

| | | |
|---|---|---|
| *Bonds* | *100,000.00* | |
| *Sinking Fund* | | *100,000.00* |
| *For redemption of outstanding bonds.* | | |

There still remains a credit balance in the Sinking Fund Reserve account of $100,000.00. Since the object of the sinking fund reserve was merely to retain a given amount of surplus until the bonds were redeemed, it is in order to transfer the sinking fund reserve back to the Earned Surplus account through the following entry:

| | | |
|---|---|---|
| *Sinking Fund Reserve* | *100,000.00* | |
| *Surplus* | | *100,000.00* |
| *For transfer of sinking fund reserve to Earned Surplus, the sinking fund having been employed to pay off the bonds.* | | |

*c*) *Betterments.* Betterments are additions to assets already owned. They result in increased earning power and it is for that reason that the expenditures made on them are properly capitalized, that is, added to the book value of the asset. Frequently business enterprises foresee the need of future betterments and take the necessary steps to insure that the necessary funds will be available when it becomes necessary to construct or purchase such betterments. One possible procedure to accomplish this desired result is to set specified sums of cash aside. Another possible procedure is to set up what are known as reserves for betterments. A reserve for betterments is created by transferring periodically from the Earned Surplus account to a Reserve for Betterments account a certain sum of money.

To illustrate, assume that Corporation K desires to establish a Reserve for betterments so that at the end of five years the Reserve for Betterments account will show a credit balance of $100,000.00. The sum of $20,000.00 is to be transferred each year from surplus. The entry at the end of each year for such transfer is as follows:

| | | |
|---|---|---|
| *Surplus* | *20,000.00* | |
| *Reserve for Betterments* | | *20,000.00* |
| *For yearly contribution to Reserve for Betterments account.* | | |

The creation of the Reserve for Betterments account guarantees the retention of surplus in the business, but it does not guarantee that the necessary cash will be available at the end of five years. The fact that the reserve for betterments exists, however, is a guaranty that the general financial condition of the enterprise will be better than if all surplus had been distributed in the form of dividends. This means that the working capital position, that is, the excess of current assets over current liabilities, should be better than if surplus had not been reserved. The provision of the necessary cash, namely, $100,000.00, is a matter of good financial management, and whether it should be accomplished by setting aside specified sums of cash or simply by so managing that there will be $100,000.00 in cash in excess of other requirements at the end of five years, is a matter which must be left to the officers and directors.

**Dividends.** Dividends may be classified in various ways. For present purposes they will be discussed under the following heads: (*a*) cash dividends, (*b*) stock dividends.

*a*) *Cash Dividends.* A cash dividend is a sum paid to stockholders in cash proportionate to their stockholdings. For example, if A, B, and C are stockholders in Corporation ABC, A owning $10,000.00 par value stock, B $20,000.00 par value stock, and C $30,000.00 par value stock, a cash dividend of 5 per cent amounting to $3,000.00 would be distributed, one-sixth to A, one-third to B, and one-half to C.

Most corporations attempt to establish what is known as a dividend policy, that is, they try to pursue a more or less well-defined plan in the declaration and payment of dividends. It may be stated as a fundamental principle that cash dividends cannot be paid except where free earned surplus equal to at least the amount of the dividend exists. Thus, in the case of Corporation ABC, the board of directors would avoid paying a dividend of $3,000.00 if there were not at least $3,000.00 of surplus available. If dividends are paid when there is no equivalent surplus, such dividends result in depletion of invested capital. This may be regarded as a fraud perpetrated against the creditors of the corporation who are entitled to look to such invested capital as a protection. Formerly much emphasis was laid upon what was known as the trust fund theory of capital stock. This theory was to the effect that invested capital of the stockholders constitutes a trust fund for the protection of creditors. Although modern authorities regard this theory as inapplicable, it is nevertheless true that the invested capital does constitute a fund for the protection of creditors, although it does not fulfill all of the requirements of a trust fund. If a board of directors declares a dividend in excess of available surplus, they render themselves personally liable for the amount of depletion in capital which results. It is for this reason that a board of directors waits until the income statement for the year is available before deciding what dividend, if any, shall be paid during the following year.

Assume that the Q Corporation has, after closing its books on December 31, 19—, earned surplus amounting to $50,000.00, and that it has outstanding $100,000.00 of 6 per cent preferred stock and $200,000.00 of common stock upon which for the past two years a dividend of 8 per cent has been declared in addition to the 6 per

cent dividend on the preferred stock. If the board of directors desires to pay the same dividends in the current year, the cash requirements will be as follows:

| | |
|---|---|
| *Preferred Stock* | *6,000.00* |
| *Common Stock* | *16,000.00* |
| *Total* | *22,000.00* |

After the board passes a resolution declaring the dividend, the following entry must be made on the books:

| | | |
|---|---|---|
| *Surplus* | *22,000.00* | |
| *Dividends Payable—Preferred Stock* | | *6,000.00* |
| *Dividends Payable—Common Stock* | | *16,000.00* |
| *For declaration of 6 per cent dividend on preferred stock and 8 per cent dividend on common stock.* | | |

The declaration of a dividend results in a definite change in the status of the Surplus account; thus in this illustration the $22,000.00 transferred is no longer a part of net worth, but it is now a definite liability which the corporation must meet. A dividend may be paid in full at whatever date is specified in the resolution declaring the dividend, but as a rule dividends are paid quarterly; thus in the foregoing illustration, it might be provided that the dividend shall be paid quarterly: March 1, June 1, September 1, and December 1. The payment of the dividend on March 1 would require the following entry:

| | | |
|---|---|---|
| *Dividends Payable—Preferred Stock* | *1,500.00* | |
| *Dividends Payable—Common Stock* | *4,000.00* | |
| *Cash* | | *5,500.00* |
| *For payment of quarterly dividend.* | | |

This entry would be repeated for each of the payments which follow on the dates indicated above.

*b*) *Stock Dividends.* A stock dividend is one paid in capital stock of the corporation paying the dividend. Of course, a dividend might be paid in the capital stock of another corporation if the corporation paying the dividend happened to own such stock. This would, however, be a kind of property dividend and need not be considered here. A stock dividend is, in effect, nothing more than an increase in the number of shares of stock outstanding. For example, suppose that Corporation L has outstanding $50,000.00 par value

of capital stock and a surplus of $25,000.00. It is decided to declare a stock dividend of 10 per cent, or $5,000.00. The entry is:

| | | |
|---|---|---|
| *Surplus* | *5,000.00* | |
| *Capital Stock* | | *5,000.00* |
| *For stock dividend of 10 per cent on outstanding capital stock.* | | |

The effect of such dividend is to reduce surplus available for dividends; thus, in the foregoing illustration the surplus is reduced from $25,000.00 to $20,000.00, the capital stock being correspondingly increased. A stock dividend has no effect on the amount of the net worth, but simply capitalizes surplus. When the number of shares of stock outstanding is increased without any increase in net worth, it is evident that each share of stock is worth less. If a corporation were to declare a stock dividend of 100 per cent, the book value of each share of outstanding stock would be reduced to one-half the book value of stock formerly outstanding. Stock dividends may, however, perform a useful purpose. Sometimes the market value of stock becomes greater than is deemed desirable; by capitalizing surplus through stock dividends, the market value of outstanding stock will be reduced.

**Treasury Stock.** A corporation may purchase its own outstanding stock. This stock is then known as treasury stock, unless it is cancelled, thus reducing the amount of authorized stock. As a rule, a corporation does not care to have its charter amended in order to reduce outstanding stock and therefore holds such stock as has been purchased in its treasury. Treasury stock must not be confused with unissued stock. Formerly, accountants frequently followed the practice of showing treasury stock as an asset on the balance sheet, but this practice has been abandoned to a large extent. Theoretically, treasury stock is a deduction from net worth and in practice it is usually so treated.

If the corporation's stock has a par value and the treasury stock has been purchased at other than par value, the difficulty in deducting the treasury stock directly from capital stock on the balance sheet is obvious. It may, however, be deducted from the total of capital stock and surplus. To illustrate, assume that Corporation K has purchased 100 shares of its total outstanding stock of 1,000 shares at a price of $110.00 per share. Assume also that the surplus

of Corporation K amounts to $25,000.00. The facts may be expressed in the balance sheet as shown in Fig. 125.

| | | |
|---|---|---|
| Capital Stock | $100,000.00 | |
| Surplus | 25,000.00 | $125,000.00 |
| Less Treasury Stock | | 11,000.00 |
| Net Worth | | $114,000.00 |

Fig. 125

In Fig. 126 the method of showing no-par treasury stock in the balance sheet is illustrated.

| | Shares | |
|---|---|---|
| Common Stock of no par value | 500,000 | |
| Issued | 390,000 | |
| In Treasury | 60,000 | |
| Outstanding | 330,000 | $26,400,000.00 |

Fig. 126

**Statement of Surplus.** In view of the importance of surplus in corporation accounting, it is desirable usually to supplement the surplus statement in the balance sheet with a more detailed statement of surplus. In Fig. 127 is given an illustration patterned after the earned surplus statement of a large American corporation.

**Earned Surplus Account**

**For the Year Ended November 30, 19—**

| | | |
|---|---|---|
| *Earned Surplus as at November 30, 19—* | | *2,700,000.00* |
| *Net Income for Year ended November 30, 19—* | | *609,000.00* |
| | | *2,091,000.00* |
| *Deduct:* | | |
| *Dividends Paid:* | | |
| *Cumulative Preferred Stock—7 per cent.* | *62,000.00* | |
| *Common Stock—$3.25 per share* | *438,000.00* | |
| *Pensions paid subsequent to Mar. 1, 19—* | *58,000.00* | |
| *Losses arising from damage caused by flood in January, 19—* | *54,000.00* | |
| *Loss on investment written off* | *29,000.00* | |
| | | *641,000.00* |
| | | *1,450,000.00* |

Fig. 127

# *Chapter* 15

# THE PARTNERSHIP

**Nature of Partnership.** The modern partnership is the result of a long process of development. It is said to have originated during the Middle Ages in Italy where it received its first considerable development. Later, the partnership was recognized by the English courts. The English courts of Law and Equity applied the law merchant to cases involving partnership and this law merchant has been recognized judicially in some of the states in this country. Owing to the meager development of commerce, the preparation of a legal treatise on partnership was not undertaken until the close of the seventeenth century, that is, about the year 1700. By way of summary, it may be said that in England the partnership was first recognized by the common law courts. Consequently, it is customary to speak of the partnership as it is known in the United States as being of common law origin.

**Advantages of Partnership Organization.** The continued popularity of the partnership form of organization indicates that many business men look upon it with favor. It is relatively simple in form and may be adopted without going through the formalities of an application to some state department, except, of course, in case of the so-called limited partnership. There seems to be no reason to believe that the order of development beginning with the sole proprietorship, passing through the partnership stage and in many cases arriving finally at the corporate form of organization will be soon changed. There are reasons why each of these three forms of organization remains popular. Of course, some sole proprietorships keep their form of organization indefinitely. The same is true of some partnerships, and it is also true that some corporations are created *de novo*, without having first taken the form of either the sole proprietorship or the partnership. Sometimes sole proprietorships are incorporated without having first passed through the partner-

ship stage. Under modern conditions an undoubted advantage of the partnership is the fact that it is required to submit relatively few reports to the state. In case of the corporation this has become a source of much expense.

**Disadvantages of Partnership Form of Organization.** The disadvantages of the partnership form of organization will be discussed under the following heads: (*a*) organization and management, (*b*) unlimited liability feature, (*c*) sources of funds, (*d*) duration.

*a*) *Organization and Management.* Necessarily the partners must be the organizers and managers of the partnership. If the number of partners is large, say eight or more, the organization becomes unwieldy, because each partner possesses equal voice with every other partner in managing partnership affairs. If a single partner proves to be incapable or inefficient, the disruption of the entire enterprise is likely to result. The difficulty in securing the association of several men capable of managing an enterprise and at the same time of affording the necessary capital is obvious. Under the corporate form of organization members need not be owners; and it is a much easier task to secure managerial ability under these conditions. A successful enterprise must have a responsible head. Divided responsibility is oftentimes inherent in the partnership form of organization because of the rule of each partner's possessing equal voice in management. Proper assignment of duties obviates the difficulty.

*b*) *Unlimited Liability Feature.* In case of the common law partnership, each partner is subject to unlimited liability for partnership debts. This means that not only partnership assets must be used for the payment of partnership debts, but also that any private property owned by the partners is subject to levy for this purpose. Naturally this is a serious consideration for one owning much property other than that which he invests in a partnership; and it is likely to prove a discouraging factor in the promotion of partnerships. As a consequence, some states have enacted laws permitting so-called limited partnerships to be formed, in which one or more of the partners is granted immunity from the unlimited liability feature on condition that he take no part in management. There must, however, be at least one partner having unlimited liability, otherwise there would be no one to manage the partnership's affairs.

Two important uniform laws have been adopted by many of the states. No less than fifteen of the states have enacted the Uniform Partnership Act, and at least six of the states have enacted the Uniform Limited Partnership Act. Whereas the purpose of the Uniform Partnership Act is primarily to codify the common law and to adopt the better interpretation where there is a conflict in the rules of the common law, the purpose of the Uniform Limited Partnership Act is to enable a partnership to limit the liability of one or more, but not all, of the partners. The liability of a limited partner extends only to his investment in the partnership. This kind of legislation undoubtedly tends to encourage retention of the partnership form of organization by granting to it certain of the attributes of the corporation. In order to take advantage of the Uniform Limited Partnership Act, it is necessary that two or more persons sign a certificate under oath. This certificate is filed in the county in which the partnership is to conduct its principal business, also in any other counties in which it may carry on operations. In addition to certain other formalities which must be met, the certificate must contain the following:

1. Name of partnership.
2. Nature of business.
3. Its location.
4. Name and residence of each partner.
5. Names of both general and limited partners.
6. Duration of partnership.
7. Contribution in cash or other forms of property to be made by each partner.
8. Additional contributions to be made later by each partner.
9. The date the investment of a limited partner is to be returned to him.
10. The compensation or share of profit each limited partner is to receive.
11. The right of a limited partner to substitute an assignee of his interest.
12. The right to admit additional limited partners.
13. The right extended to one or more limited partners to enjoy priority over other limited partners as regards contributions and division of income.
14. The arrangement whereby a retiring limited partner may ask property instead of cash for his contribution.
15. The right of the remaining general partners to continue the business after the death, retirement, or incapacitation of a partner.

*c) Sources of Funds.* The partnership must secure most of its funds from the partners. It is true that some money can be obtained

from banks, some by mortgaging property owned by the partnership, and some by buying on credit. Nevertheless, the investment of the partners must provide the basis for development. This may prove to be a somewhat limited source of funds owing to the limited number of partners. In this respect the partnership is at a decided disadvantage, as compared with the corporation. The corporation can appeal to an almost unlimited number of investors, because of the manner in which capital stock is subdivided and because of the strict limitation on liability of stockholders which is usually fixed at the par value of the capital stock which they own.

Profits retained in the business, by being transferred to the capital accounts of the partners, may be regarded as an additional source of funds. This is equivalent to the investment of money by the partners. It is the same as if all profits were distributed to partners and then some or all thereof invested by the partners to whom they were distributed.

*d) Duration.* The duration of a given partnership ends when any one of the partners dies or retires from the business. This means that partnership affairs must be accounted for strictly to date of such death or retirement and then the partnership be dissolved; or else a settlement must be made with the estate of the deceased partner or retiring partner and a new partnership formed. This may prove to be a serious problem, whatever is done. These difficulties do not inhere in the corporation. The death of a stockholder affects the corporation in no way whatever. The capital stock which he owns is transmitted like other personal property and all that is necessary is to have it transferred on the corporation's books.

**Partnership Law.** Some mention already has been made of partnership law, its origin and present status. At this point further consideration of specific provisions of partnership law applicable in this country will be explained.

The definition of a partnership found in the Uniform Partnership Act is: "A partnership is an association of two or more persons to carry on as co-owners, a business for profit."

The fact that a partnership is an *association* is of peculiar significance in law. Out of this fact there develop certain important conclusions relative to the manner in which partnerships may sue and

be sued, and also relative to partnership debts. Each partner is regarded as an agent of the association and is able to bind the association so long as he acts within his powers. These powers of the agent may be either expressed or implied. An express power is one definitely stated in the agent's authority. An implied power is one not stated but which may be inferred from the circumstances. Thus, if a partnership is engaged in the hardware business, it would be implied that a partner could make purchases of hardware.

The tests which are applied to determine the qualifications of a partner are essentially legal in character. As a rule, any natural person possessing the power to contract may become a partner. If an infant becomes a partner, his agreement is a valid one but is voidable at his option, as are other contracts made by infants.

Whether or not an association of individuals in any given instance is a true partnership or not is a matter of interpretation. Below will be considered, briefly, some of the tests which may be applied to determine whether or not an association is a partnership.

*a*) *Profits.* No association of individuals is a partnership unless it operates with a view to the making of a profit. However, it is possible that an association may have as its object the making of a profit and yet not be a partnership.

Whereas the intention to make a profit is essential to the existence of a partnership, the mere sharing of profits is not proof that *a partnership exists.* It is, however, evidence that a *partnership does exist.* One may participate in profits in other capacities than that of partner. Whether or not a partnership exists where profits are shared depends largely upon the intention of the partners. Thus, an agreement to share profits is a strong indication that a partnership exists. Frequently, employees share in the profits of an enterprise without having an interest which would make them partners.

*b*) *Single vs. Multiple Transactions.* Frequently, there are formed joint ventures which have as their object the completion of a single transaction or undertaking with a view to the making of a profit. Such a venture is not a partnership, unless it is the intention of the members thereof that it shall be a partnership, in which event it is a partnership notwithstanding the fact that it is intended to carry out a single transaction.

*c*) *Manner of Holding Property.* As a rule, partnership property is held under tenancy in common, but the fact that property is held under this rule of law is not proof that a partnership exists. It is merely an indication that a partnership may exist. Partnership property may be held in other ways, as is explained in section 7 of the Uniform Partnership Act, which states that joint tenancy, tenancy in common, as well as other bases of holding property do not establish a partnership.

The following quotation from the Uniform Partnership Act states the rule for determining the existence of a partnership.

(1) Except as provided by section 16 persons who are not partners as to each other are not partners as to third persons.

(2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by use of the property.

(3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

(4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:

- (*a*) As a debt by installments or otherwise,
- (*b*) As wages of an employee or rent to a landlord,
- (*c*) As an annuity to a widow or representative of a deceased partner,
- (*d*) As interest on a loan, though the amount of payment vary with the profits of the business,
- (*e*) As the consideration for the sale of the goodwill of a business or other property by installments or otherwise.

**Forms of Partnerships.** Below are described some of the more usual forms of the partnership.

A *general partnership* is one in which two or more persons associate together to carry on a business under the usual common law requirements relative to liability. Neither a written nor an oral agreement is essential to make such an association a partnership, although there usually is a contract to that effect.

A *limited partnership* is one formed in conformity with state laws; as already explained certain but not all of the partners may be granted limited liability, being liable only to the extent of their investment in the business. It appears that the limited partnership

laws which have been passed in certain of the states are modeled in a general way after Louisiana limited partnerships.

A *partnership by estoppel* is one which results when a person represents himself to be a partner and thus permits other parties to act on the assumption that he is telling the truth. He is said to be a partner by estoppel because he is estopped to deny that he is a partner. In other words, he is prevented from denying the assertion which leads others to assume him to be a partner.

A *defective corporation* may have failed to such an extent to comply with the corporation law of the state as to render its members liable as partners. If, however, the corporation has complied essentially with the requirements of law it is a corporation *de facto*.

A *joint venture* is an association of two or more individuals for the purpose of accomplishing a prescribed act. Such a joint venture may be a partnership if it is the intention of the members to be so regarded.

A *mining partnership* is similar to other partnerships in some respects, but it may be given peculiar rights and powers by state law. Thus, in California a partner is permitted to convey his interest in the enterprise without liquidating the firm.

A *special partnership* is similar to a joint venture in that it is organized to accomplish a single undertaking.

A *universal partnership* is one in which the partners agree that all of their property shall be held in common.

A *joint stock company* is a partnership in which the net worth is represented by transferable shares. The unlimited liability feature exists, however, although management may be delegated to a board of directors. Joint stock companies are not incorporated and pay no organization tax. A notable feature of the joint stock company is that members cannot act for it, but only such agents as are authorized to do so.

A *limited partnership association* may be organized under the laws of Pennsylvania and Michigan. Ownership is represented by shares of stock. The business of the association is managed by a board of directors elected by the stockholders. Essentially these associations are corporations since, within the state in which they organized, the limited liability feature applies to all stockholders.

**The Partnership Agreement.** Since the partnership is of common law origin and is governed by the rules of the common law, except where special legislation intervenes, partners are usually free to make such agreement relative to the organization and conduct of the firm as they see fit. Sometimes these agreements are merely oral in character, but it is better practice to reduce the partnership agreement to writing. Association as partners gives rise to many situations which should, if possible, be prepared for in advance by having a well-thought-out partnership agreement. It is impossible to foresee all possible disputes which may arise, but it is possible to prevent many disputes by providing in the agreement for such matters as loans from partners, division of profits and losses, drawings, and interest on excess drawings. It may be desirable to consult with an attorney skilled in the preparation of such agreements. Below are listed some of the things which are likely to deserve consideration in the partnership agreement.

1. Name of the firm.
2. Location of the firm's business.
3. Date of agreement and date of commencement of partnership business.
4. Names and addresses of the partners.
5. If all partners possess unlimited liability, it should be so specified.
6. If there are two or more classes of partners, each class should be indicated and the powers and liabilities of the members of each group clearly set forth.
7. The contribution to be made to the firm by each partner.
8. The nature of the partnership business together with such limitations as may be necessary to avoid entrance into projects not contemplated in the agreement.
9. The duties of each partner. These should be indicated with sufficient clearness to avoid any possibility of misunderstanding after operations have begun.
10. The ratio in which profits and losses are to be distributed to partners.
11. Compensation of partners and whether or not such compensation is to be regarded as expense or as profit distribution.
12. Date partnership is to be dissolved if it is desirable to predetermine such date.
13. How withdrawals of members of the firm shall be made.
14. Method of arbitrating, or settling, questions in dispute among the partners.

**Rights and Duties of Partners.** The Uniform Partnership Act provides that a partner shall have the following property rights: (1) right in specific partnership property, (2) interest in the partnership, (3) right to take part in management.

1. The partner's right in specific property is conditioned upon the fact that the partners are co-owners, under which form of owning property, subject only to qualifications in the partnership agreement, the partners have equal rights in partnership property. The rights which a partner has in partnership property exist only with reference to its use for partnership purposes. It would require the special consent of all other partners to enable one partner to use partnership property. Under co-ownership a partner merely has an interest in all of the assets but he does not own completely any particular asset, consequently, he cannot sell or assign any property, except when all of the other partners act with him. Owing to the common interest of all partners in partnership property, it is not subject to attachment by creditors of members of the partnership. The following is quoted from the Uniform Partnership Act:

(1) A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

(2) The incidents of this tenancy are such that:

(a) A partner, subject to the provisions of this act and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.

(b) A partner's right in specific partnership property is not assignable, except in connection with the assignment of the rights of all the partners in the same property.

(c) A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt, the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead or exemption laws.

(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

(e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin.

2. As regards a partner's interest in the partnership, the partner has certain limited rights. For example, there exists the right to wind up the partnership's affairs in case of dissolution. There also is the right which each partner has, when dissolution occurs, to dis-

charge its liabilities and to have the surplus paid in cash to the respective partners. In case of distribution following dissolution, the partners have the right to have the liabilities paid in proper order. The Uniform Partnership Act provides that liabilities of the partnership shall rank in order of payment as follows: (1) those owing to creditors other than partners, (2) those owing to partners other than for capital and profits, (3) those owing to partners in respect to capital, (4) those owing to partners in respect to profits.

3. Relative to the right of a partner to take part in management, the following is quoted from the Uniform Partnership Act:

> (1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.
>
> (2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.
>
> (3) Unless authorized by other partners or unless they have abandoned the business, one or more but less than all the partners have no authority to:
>
> (a) Assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,
> (b) Dispose of the good-will of the business,
> (c) Do any other act which would make it impossible to carry on the ordinary business of a partnership,
> (d) Confess a judgment,
> (e) Submit a partnership claim or liability to arbitration or reference
>
> (4) No act of a partner in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction.

**Compensation of Partners.** As regards ownership, a partner holds a position similar to that of a sole proprietor, except that his ownership is not 100 per cent. It is evident that net profit before any salaries are paid is the measure of success of either a sole proprietorship or a partnership, and that any compensation paid to a partner is simply a reduction of net profit. In other words, drawings made by a sole proprietor or so-called salaries paid to partners are in reality distribution of profit. Salaries paid employees fall into a different category. They are true expenses and must be so treated in the Profit and Loss account. Notwithstanding their true nature,

partners' salaries are sometimes regarded as expenses; there is no theoretical justification for this. The payment of a salary to one partner obviously results in a different distribution of profits than when all profits are divided in the profit and loss sharing ratio. Therefore, salaries paid to one or more partners in effect result in an adjustment as regards the distribution of profits.

To illustrate, assume that A, B, and C are partners sharing profits and losses equally. A's net worth is $100,000.00, B's is $50,000.00, and C's is $25,000.00. C acts as manager, giving all of his time to the business, while A and B give none of their time to the business. It is evident that an equal division of all profits would result in injustice. The situation might be remedied by allowing interest at 6 per cent on the investment and by paying C a salary of, say, $4,000.00 a year. Assuming that in a given year net profit amounts to $20,000.00, this would be distributed as follows:

| | |
|---|---|
| *A 6 per cent on 100,000.00* | *6,000.00* |
| *B 6 per cent on 50,000.00* | *3,000.00* |
| *C 6 per cent on 25,000.00* | *1,500.00* |
| *C's salary* | *4,000.00* |
| | *14,500.00* |
| *Net profit for year* | *20,000.00* |
| *Less salary and interest* | *14,500.00* |
| *Balance to be shared equally* | *5,500.00* |

The confusion relative to partners' salaries results from the fact that, in general, salaries are expenses and should be so treated. It is evident, however, that an individual cannot pay a salary to himself and for the same reason salaries paid to partners are merely profit distributions notwithstanding the fact that such so-called salaries are sometimes justified. Partners' salaries are simply one aspect of the division of profits and losses.

As to the division of profits and losses, the agreement of the partners controls. Nothing being said in the agreement relative thereto, profits and losses are shared equally, regardless of the amounts invested by the respective partners and regardless also of the services performed by the respective partners. It is impossible to indicate what all such agreements might provide for, but a few assumed cases will assist the student to secure an understanding of the problems involved.

*Case 1.* Assume that A and B are partners, each having an investment of $20,000.00. If nothing is said in the agreement relative to distribution of profits and losses, they will be divided equally, but A and B may agree to any distribution they see fit. Thus A might receive 40 per cent and B 60 per cent of the profits and losses.

*Case 2.* Assume that A and B are partners, A's investment being $50,000.00 and B's $10,000.00. Nothing being said relative to profit and loss distribution, they will be divided equally notwithstanding the difference in the investments of the two partners. A possible arrangement might be for interest to be allowed at, say, 7 per cent on the respective investments of $50,000.00 and $10,000.00, remaining profits to be divided equally.

*Case 3.* Assume that A, B, and C are partners having investments of $75,000.00, $50,000.00, and $25,000.00 respectively. Nothing being said regarding profit and loss distribution, they will be divided equally even though C, whose investment is $25,000.00, serves as manager. A possible arrangement, however, might be to pay C a salary of $3,000.00 and to allow interest on invested capital at 6 per cent, remaining profits to be divided equally.

**Partnership Dissolution.** According to the Uniform Partnership Act, the dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on of the business. Dissolution does not result in the termination of the partnership which must be continued until the winding up of partnership affairs is completed.

According to the Uniform Partnership Act the causes of dissolution are as follows:

(1) Without violation of the agreement between the partners,
- (*a*) By the termination of the definite term or particular undertaking specified in the agreement,
- (*b*) By the express will of any partner when no definite term or particular undertaking is specified,
- (*c*) By the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,
- (*d*) By the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners;

(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;

(3) By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

(4) By the death of any partner;

(5) *By the bankruptcy of any partner or the partnership;*

(6) By decree of court.

The sixth manner of dissolution listed above, by decree of court, requires some elaboration. It may result (1) from the application either by or for a partner, or (2) it may result from the application of the purchaser of a partner's interest under certain conditions. The causes which may justify application for dissolution by or for a partner are as follows:

*a*) A partner has been declared a lunatic in any judicial proceeding or is shown to be of unsound mind,

*b*) A partner becomes in any other way incapable of performing his part of the partnership contract,

*c*) A partner has been guilty of such conduct as tends to affect prejudicially the carrying on of the business,

*d*) A partner willfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him,

*e*) The business of the partnership can only be carried on at a loss,

*f*) Other circumstances render a dissolution equitable.

# *Chapter* 16

# PARTNERSHIP ACCOUNTING

**Interests Involved.** The purpose of all accounting is to protect the interests of all of the equity holders in a given enterprise. In a sole proprietorship the equity holders are the creditors and the proprietor. In a partnership the equity holders are the creditors and the partners. As between the equity holders in a given business there naturally arise conflicting interests. The settlement of these conflicts cannot be accomplished unless there is forthcoming information necessary for the correct carrying out of all agreements. An equity holder in an enterprise must have recourse to contracts or other information which will enable him to substantiate his demands for just treatment. Thus short-term creditors who have extended credit to the enterprise for merchandise sold can refer to correspondence, invoices, and contracts. The mortgagee can refer to recorded documents. The partners should be able to refer to a carefully formulated partnership agreement in which are set forth all of the information necessary for the settlement of whatever questions may arise relative to such matters as the division of profits and losses, drawings and interest on excess drawings, treatment of salaries, loans from partners, and so on.

There is a trend in some modern writers on accounting to minimize the distinction between the equities of proprietors and those of creditors. It is believed, however, that the beginner in the study of accounting will do well to emphasize the differences rather than the likenesses between the two important groups of equity holders, namely, the proprietors and the creditors. In the first place, the proprietors hold the legal title to all of the assets, and they maintain this position as long as they continue to meet their responsibilities to creditors. In the second place, the equities of creditors have definite time limits, whereas the equities of proprietors are usually without such limitation. Of course, if a partner lends money to his

firm, it may be specified that the loan must be repaid within a given period of time, but in case of investments this is not a condition because investments of proprietors or partners do not mature and need not be repaid, except in unusual circumstances, such as, for example, the liquidation of the enterprise. In the third place, the risks which the creditors bear are not the same as those which the proprietors bear. The proprietors are the primary risk bearers in any enterprise. Losses must first be written off against proprietorship equities before credit equities can be reduced. In other words, no creditor stands to lose a penny as long as there exists any net worth. Only after all proprietorship equities have disappeared may there occur reduction in some or all of the creditors' equities.

An equity originates in one of several ways, of which the following are illustrative:

1. Merchandise is purchased, $100.00. The entry is as follows:

| | | |
|---|---|---|
| *Purchases* | 100.00 | |
| *John Jones* | | 100.00 |

In this case the equity consists in the liability to John Jones which must be liquidated within a relatively short time.

2. A court judgment is rendered against an enterprise for the amount of $500.00 in favor of a competing concern, the Gulf Company. The entry is as follows, assuming that the enterprise in question is a corporation:

| | | |
|---|---|---|
| *Surplus* | 500.00 | |
| *Gulf Company* | | 500.00 |

In this case the equity arises as the result of a court judgment and must be paid within the period specified in the judgment.

3. John Smith is a sole proprietor. He desires to invest an additional $100.00 in his business. The entry is as follows:

| | | |
|---|---|---|
| *Cash* | 100.00 | |
| *John Smith, Net Worth* | | 100.00 |

In this case an equity arises which has no maturity since John Smith owns the business and expects to operate indefinitely.

4. The Profit and Loss account of John Smith shows a credit balance of $1,345.21 at the end of a given year. This may be transferred to his Net Worth account by the following entry:

| | | |
|---|---|---|
| *Profit and Loss* | *1,345.21* | |
| *John Smith, Net Worth* | | *1,345.21* |

In this case the increase in Smith's equities arises out of the profits of the business. It is obvious that such profits could not possibly accrue to or increase the equities of creditors. This emphasizes the distinction between a proprietorship equity and a creditor equity.

5. Assume that John Smith and Arthur Jones desire to form a partnership. Smith invests $5,000.00 and Jones invests $10,000.00. The entry to show these investments is as follows:

| | | |
|---|---|---|
| *Cash* | *15,000.00* | |
| *John Smith, Capital* | | *5,000.00* |
| *Arthur Jones, Capital* | | *10,000.00* |

In this case a business enterprise is established and the two original equities result. Of course, the number of equities will soon increase because purchases will be made on account. In other words, there will be added to the proprietorship equities certain creditor equities.

It is an important problem of management to maintain a desirable relationship between the various equities. Thus, if proprietorship equities become reduced to 10 per cent of total equities, the business may be said to be operating on a shoestring. If, on the other hand, proprietorship equities amount to 75 per cent of the total equities, the enterprise may be said to be in a stable condition and obviously involves less risk than does an enterprise less favorably situated.

In partnership accounting equities are of peculiar significance because of the relationships among the partners which they represent. The equity status of a sole proprietorship is simple, but the equity status of a partnership is likely to be complicated. It is this situation which gives rise to the necessity of distinguishing carefully between the interests of the partners, and to do this it is necessary to operate, for each partner, both a Capital account and a Drawing account. Of course, if a partner lends money to his firm it is necessary to operate also a Loan account. It may be said, therefore, that Capital accounts, Drawing accounts, and Loan accounts are the distinguishing features of partnership accounting. The function of each of these accounts will be explained briefly.

The *Capital account* shows the amount of a partner's investment in the firm. There is, of course, normally a credit balance in the Capital account. It is only where losses have absorbed all of one or more of the partners' investments that debit balances appear in their Capital accounts. Sometimes additional investments may be credited to a partner's Capital account and from the Drawings account, at the end of each accounting period, must be transferred whatever balance results in that account.

The *Drawings account* is opened at the beginning of each accounting period for the purpose of reflecting on the debit side drawings made by a partner against his share of the partners' profits. Since his share of the partners' profits cannot be credited to his Drawings account until the end of the period, there is likely to appear in the Drawings account one or more debit items. These, of course, will be offset by the credit which ultimately results from the transfer of the partner's share of net profits, assuming that a net profit is made; also there may be made against the Drawings account certain adjustments for interest. These adjustments are usually either adjustments for interest on partners' loans or they are adjustments for interest on partners' drawings. These will be explained fully later in this chapter.

The *Loan account* is used in partnership accounting to express indebtedness of the firm to one of the partners. Loans from partners must be clearly distinguished from investments of the partners. An investment represents an increase in net worth, but a loan secured from a partner represents a liability which must be liquidated in the same way as other liabilities. Whereas, interest is allowed on partners' investments only for purposes of adjustment, interest on loans from partners is of the same nature as interest on other loans, that is, an expense.

**Distinctive Accounts.** As indicated in preceding paragraphs, the distinctive accounts in partnership accounting are: (*a*) Capital accounts, (*b*) Drawings accounts, (*c*) Loan accounts.

In order to secure an understanding of the operation of these accounts an illustration involving all of them will be given.

John Smith and Arthur Jones form a partnership for the purpose of engaging in the retail hardware business. Smith invests $5,000.00

and Jones invests $10,000.00. The date of commencement of the business is January 1, 19—. The journal entry to express the investments of the partners is as follows:

| | | |
|---|---|---|
| | *January 1, 19—* | |
| *Cash* | *15,000.00* | |
| *John Smith, Capital* | | *5,000.00* |
| *Arthur Jones, Capital* | | *10,000.00* |
| *For investment of partners to engage in retail hardware business at 221 North State Street.* | | |

It is provided in the partnership agreement that profits are to be divided equally after allowing 6 per cent interest on the partners' net worth accounts as at the beginning of the year. Drawings are to be limited to $600.00 for each partner in a given year and must not exceed $100.00 in any month. Assume that at the end of the first year the Profit and Loss account shows a credit balance of $5,000.00 and that the Profit and Loss account, Capital accounts, and Drawings accounts appear as shown in Fig. 128.

**Profit and Loss**

| | | | |
|---|---|---|---|
| | | *19—* | |
| | | *Dec. 31* | *5,000.00* |

**John Smith, Capital**

| | | | |
|---|---|---|---|
| | | *19—* | |
| | | *Jan. 1 Cash* | *5,000.00* |

**Arthur Jones, Capital**

| | | | |
|---|---|---|---|
| | | *19—* | |
| | | *Jan. 1 Cash* | *10,000.00* |

**John Smith, Drawings**

| | | | |
|---|---|---|---|
| *March 16 Cash* | *90.00* | | |
| *Aug. 25 Cash* | *100.00* | | |
| *Aug. 28 Cash* | *100.00* | | |

**Arthur Jones, Drawings**

| | | | |
|---|---|---|---|
| *June 12 Cash* | *100.00* | | |
| *Dec. 15 Cash* | *100.00* | | |

Fig. 128

It is necessary to make an adjusting entry for interest on the partners' Net Worth accounts, the rate being 6 per cent. This ad-

justment consists in a charge to Profit and Loss and a credit to the partners' Drawings accounts. The entry is as follows:

*December 31, 19—*

| | | |
|---|---|---|
| *Profit and Loss* | 900.00 | |
| *John Smith, Drawings* | | 300.00 |
| *Arthur Jones, Drawings* | | 600.00 |
| *To allow interest at 6 per cent on partners' investments at beginning of year.* | | |

This leaves a credit balance in the Profit and Loss account of \$4,100.00, which is divided equally between the partners by the following closing entry:

*December 31, 19—*

| | | |
|---|---|---|
| *Profit and Loss* | 4,100.00 | |
| *John Smith, Drawings* | | 2,050.00 |
| *Arthur Jones, Drawings* | | 2,050.00 |
| *To close the profit to partners' Drawings accounts.* | | |

There remains a credit balance of \$2,060.00 in Smith's Drawings account and a credit balance of \$2,450.00 in Jones's Drawings account. These balances are transferred to the Capital accounts of the partners by the following closing entries:

*December 31, 19—*

| | | |
|---|---|---|
| *John Smith, Drawings* | 2,060.00 | |
| *John Smith, Capital* | | 2,060.00 |
| *To close.* | | |
| *Arthur Jones, Drawings* | 2,450.00 | |
| *Arthur Jones, Capital* | | 2,450.00 |
| *To close.* | | |

After these entries are posted the accounts appear as follows (Fig. 129):

**Profit and Loss**

| | | | | | | |
|---|---|---|---|---|---|---|
| *19—* | | | *19—* | | | |
| *Dec. 31* | *Smith—Drawings* | 300.00 | *Dec. 31* | | 5,000.00 |
| *Dec. 31* | *Jones—Drawings* | 600.00 | | | |
| *Dec. 31* | *To Close* | 4,100.00 | | | |
| | | 5,000.00 | | | 5,000.00 |

**John Smith, Capital**

| | | | | | |
|---|---|---|---|---|---|
| | | | *19—* | | |
| | | | *Jan. 1* | *Cash* | 5,000.00 |
| | | | *Dec. 31* | *Drawings* | 2,060.00 |

**Arthur Jones, Capital**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | 19— | | | |
| | | | | Jan. 1 | Cash | | 10,000.00 |
| | | | | Dec. 31 | Drawings | | 2,450.00 |

**John Smith, Drawings**

| | | | | | | |
|---|---|---|---|---|---|---|
| 19— | | | 19— | | | |
| Mar. 16 | Cash | 90.00 | Dec. 31 | Interest | 300.00 |
| Aug. 25 | Cash | 100.00 | Dec. 31 | Profit and Loss | 2,050.00 |
| Aug. 28 | Cash | 100.00 | | | |
| Dec. 31 | John Smith, Capital | 2,060.00 | | | |
| | | 2,350.00 | | | 2,350.00 |

**Arthur Jones, Drawings**

| | | | | | |
|---|---|---|---|---|---|
| 19— | | | 19— | | |
| June 12 | Cash | 100.00 | Dec. 31 | Interest | 600.00 |
| Dec. 15 | Cash | 100.00 | Dec. 31 | Profit and Loss | 2,050.00 |
| Dec. 31 | A. Jones, Capital | 2,450.00 | | | |
| | | 2,650.00 | | | 2,650.00 |

Fig. 129

To illustrate the operation of the partner's Loan account, assume that on January 15, 19—, Arthur Jones lends $1,000.00 to the firm of Smith and Jones with the provision that it is to be paid at the end of one year with interest at 6 per cent, payable semiannually. The entry at the time the loan is made, on January 15, 19—, is as follows:

| | | |
|---|---|---|
| *Cash* | *1,000.00* | |
| *Arthur Jones* | | *1,000.00* |
| *For loan of 1,000.00 to firm, interest at 6 per cent, payable semi-annually. Loan to be repaid one year from date.* | | |

The first interest payment will fall due on July 15, and will be paid as follows:

| | | |
|---|---|---|
| *Interest Expense* | *30.00* | |
| *Cash* | | *30.00* |
| *For interest on loan from Arthur Jones.* | | |

Since the next interest payment is not until January 15, when the principal sum of the loan must also be paid, it is necessary on December 31, 19—, to make an adjusting entry for interest accrued for 5½ months. This adjusting entry is as follows:

| | | |
|---|---|---|
| *Interest Expense* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *27.50* | |
| *Interest Accrued* . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *27.50* |
| *For interest accrued for 5½ months on loan from Arthur Jones.* | | |

This entry is reversed on January 1 of the following year. On January 15 of the following year, when the principal sum falls due, the entry is as follows:

| | | |
|---|---|---|
| *Arthur Jones* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *1,000.00* | |
| *Interest Expense* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *60.00* | |
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *1,060.00* |
| *For repayment of loan to Arthur Jones with interest for 6 months.* | | |

**Partners' Salaries.** As a rule, it is illogical for sole proprietors and partners to pay salaries to themselves. This is because the only remuneration which a proprietor, whether he be a sole proprietor or a partner, can obtain from his business is the profit which he is able to make. Therefore, any salary which is paid to a proprietor must obviously be disbursed from profits or else must represent a return of investment. It is evident, however, that where one partner gives all of his time to the management and operation of the business while another partner gives little or no time to this work, some adjustment may be desirable. This adjustment made to secure equity among the partners might take the form of a changed ratio of profit distribution, or it might take the form of an interest adjustment. More likely, however, it will take the form of a direct salary payment to the partner who deserves special consideration on account of the work which he performs. Regardless of the manner in which the salary payment is entered on the books, whether as expense or as a profit distribution, there remains just that much less profit for division between the partners in the profit and loss sharing ratio.

To illustrate, assume that in the firm of Brown and Green, Brown acts as manager and receives a salary of $200.00 a month, the profit remaining being divided equally between Brown and Green. The payment to Brown at the end of each month might be expressed in either of the following ways:

| | | |
|---|---|---|
| *Salaries Expense* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | *200.00* | |
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | *200.00* |
| *For monthly salary payment to Brown.* | | |

An alternative entry would be:

| | | |
|---|---|---|
| *Brown, Drawings* . . . . . . . . . . . . . . . . . . . . . . . | *100.00* | |
| *Green, Drawings* . . . . . . . . . . . . . . . | *100.00* | |
| *Cash* . . . . . . . . . . . . . . . . . . . . . . . . | | *200.00* |

*For monthly salary payment to Brown.*

If Brown and Green share profits and losses equally, it is evident that these two methods of entering the payment of the salary to Brown have in effect the same result. In the first entry the salary is called an expense, in the second entry it is treated in effect as a distribution of profit, but the ultimate increment in capital accruing to Brown and Green, respectively, is the same in either case.

If, however, the profits are not divided equally, the results would be different under the two methods, since the charge of $100.00 to each of the Drawings accounts results in an equal distribution of the so-called salary. Suppose that the profit and loss sharing ratio is Brown 66⅔ per cent and Green 33⅓ per cent. It is evident that the plan of charging Brown's salary to the Drawings accounts favors Brown, since the balance in the Profit and Loss account to be divided in the ratio 2–1 is larger than it would be if the charge were made to a Salaries Expense account.

**Closing Partnership Books.** In order to show clearly the procedure involved in partnership accounting and the closing of partnership books, an illustration will be given. In Fig. 130 is shown the trial balance of the firm of A, B, and C as at December 31, 19—.

In the partnership agreement it is provided that drawings in excess of $3,000.00 shall be charged interest at the rate of 6 per cent. A exceeded the $3,000.00 limit when he drew $2,000.00 on July 1. Depreciation on machinery and equipment should be computed at the rate of 10 per cent per annum and on delivery equipment at the rate of 20 per cent per annum. An addition to Reserve for Bad Debts account equivalent to 0.5 per cent of accounts receivable should be made. The merchandise inventory on hand December 31, 19—, amounts to $72,500.00. Profits are divided equally after allowing 6 per cent interest on the Capital accounts of the partners as at the beginning of the year. This interest is to be credited to the partners' Drawings accounts and charged to Profit and Loss account.

The adjusting entries are shown below Fig. 130.

**Firm of A, B, and C**

TRIAL BALANCE

**December 31, 19—**

| | Debit | Credit |
|---|---|---|
| *Cash* | 20,000.00 | |
| *Accounts Receivable* | 36,000.00 | |
| *Notes Receivable* | 4,000.00 | |
| *Merchandise Inventory, Dec. 31, 19—* | 70,000.00 | |
| *Machinery and Equipment* | 45,000.00 | |
| *Delivery Equipment* | 4,000.00 | |
| *A Drawings* | 5,000.00 | |
| *B Drawings* | 3,000.00 | |
| *C Drawings* | 2,000.00 | |
| *Reserve for Depreciation—Machinery and Equipment* | | 20,000.00 |
| *Reserve for Depreciation—Delivery Equipment* | | 1,000.00 |
| *Reserve for Bad Debts* | | 2,500.00 |
| *Accounts Payable* | | 15,000.00 |
| *Accrued Expenses* | | 1,200.00 |
| *A Capital* | | 70,000.00 |
| *B Capital* | | 70,000.00 |
| *C Capital* | | 20,000.00 |
| *Sales* | | 350,000.00 |
| *Cash Discounts on Purchases* | | 1,100.00 |
| *Cash Discounts on Sales* | 800.00 | |
| *Purchases* | 165,000.00 | |
| *Factory Labor* | 142,000.00 | |
| *Factory Expenses* | 12,000.00 | |
| *Selling Expenses* | 19,000.00 | |
| *General Expense* | 23,000.00 | |
| | 550,800.00 | 550,800.00 |

Fig. 130

*December 31, 19—*

| | | |
|---|---|---|
| *A Drawings* | 60.00 | |
| *Interest on Excess Drawings* | | 60.00 |
| *For interest on A's excess drawings for 6 months.* | | |
| *Depreciation Expense—Machinery and Equipment* | 4,500.00 | |
| *Reserve for Depreciation—Machinery and Equipment* | | 4,500.00 |
| *For depreciation at rate of 10 per cent per annum.* | | |
| *Depreciation Expense—Delivery Equipment* | 800.00 | |
| *Reserve for Depreciation—Delivery Equipment* | | 800.00 |
| *For depreciation at rate of 20 per cent per annum.* | | |
| *Bad Debts Expense* | 180.00 | |
| *Reserve for Bad Debts* | | 180.00 |
| *For an allowance of 0.5 per cent of outstanding accounts receivable.* | | |

After these adjusting entries are posted, an adjusted trial balance of the ledger appears as shown in Fig. 131.

**Firm of A, B, and C**

ADJUSTED TRIAL BALANCE

**December 31, 19—**

| | Debit | Credit |
|---|---|---|
| *Cash* | 20,000.00 | |
| *Accounts Receivable* | 36,000.00 | |
| *Notes Receivable* | 4,000.00 | |
| *Merchandise Inventory, Dec. 31, 19—* | 70,000.00 | |
| *Machinery and Equipment* | 45,000.00 | |
| *Delivery Equipment* | 4,000.00 | |
| *A Drawings* | 5,060.00 | |
| *B Drawings* | 3,000.00 | |
| *C Drawings* | 2,000.00 | |
| *Reserve for Depreciation—Machinery and Equipment* | | 24,500.00 |
| *Reserve for Depreciation—Delivery Equipment* | | 1,800.00 |
| *Reserve for Bad Debts* | | 2,680.00 |
| *Accounts Payable* | | 15,000.00 |
| *Accrued Expenses* | | 1,200.00 |
| *A Capital* | | 70,000.00 |
| *B Capital* | | 70,000.00 |
| *C Capital* | | 20,000.00 |
| *Sales* | | 350,000.00 |
| *Cash Discounts on Purchases* | | 1,100.00 |
| *Cash Discounts on Sales* | 800.00 | |
| *Purchases* | 165,000.00 | |
| *Factory Labor* | 142,000.00 | |
| *Factory Expenses* | 12,000.00 | |
| *Selling Expenses* | 19,000.00 | |
| *General Expense* | 23,000.00 | |
| *Interest on Excess Drawings* | | 60.00 |
| *Depreciation Expense—Machinery and Equipment* | 4,500.00 | |
| *Depreciation Expense—Delivery Equipment* | 800.00 | |
| *Bad Debts Expense* | 780.00 | |
| | 556,340.00 | 556,340.00 |

Fig. 131

The closing entries are as follows:

*December 31, 19—*

| | | |
|---|---|---|
| *Purchases* | 70,000.00 | |
| *Merchandise Inventory Dec. 31, 19—* | | 70,000.00 |
| *To close opening inventory to Purchases account.* | | |
| *Merchandise Inventory Dec. 31, 19—* | 72,500.00 | |
| *Purchases* | | 72,500.00 |
| *To credit closing inventory to Purchases account.* | | |
| *Profit and Loss* | 162,500.00 | |
| *Purchases* | | 162,500.00 |
| *To close adjusted purchases to Profit and Loss account.* | | |
| *Sales* | 350,000.00 | |
| *Profit and Loss* | | 350,000.00 |
| *To close.* | | |

| | | |
|---|---|---|
| *Cash Discounts on Purchases* | 1,100.00 | |
| *Profit and Loss* | | 1,100.00 |
| *To close.* | | |
| *Profit and Loss* | 800.00 | |
| *Cash Discounts on Sales* | | 800.00 |
| *To close.* | | |
| *Profit and Loss* | 142,000.00 | |
| *Factory Labor* | | 142,000.00 |
| *To close.* | | |
| *Profit and Loss* | 12,000.00 | |
| *Factory Expenses* | | 12,000.00 |
| *To close.* | | |
| *Profit and Loss* | 19,000.00 | |
| *Selling Expenses* | | 19,000.00 |
| *To close.* | | |
| *Profit and Loss* | 23,000.00 | |
| *General Expenses* | | 23,000.00 |
| *To close.* | | |
| *Interest on Excess Drawings* | 60.00 | |
| *Profit and Loss* | | 60.00 |
| *To close.* | | |
| *Profit and Loss* | 4,500.00 | |
| *Depreciation Expense—Machinery* | | 4,500.00 |
| *To close.* | | |
| *Profit and Loss* | 800.00 | |
| *Depreciation Expense—Delivery Equipment* | | 800.00 |
| *To close.* | | |
| *Profit and Loss* | 180.00 | |
| *Bad Debts Expense* | | 180.00 |
| *To close.* | | |
| *Profit and Loss* | 9,600.00 | |
| *A Drawings* | | 4,200.00 |
| *B Drawings* | | 4,200.00 |
| *C Drawings* | | 1,200.00 |
| *To allow interest at 6 per cent on capital.* | | |
| *A Drawings* | 7,740.00 | |
| *B Drawings* | 7,740.00 | |
| *C Drawings* | 7,740.00 | |
| *Profit and Loss* | | 23,220.00 |
| *To close.* | | |
| *A Capital* | 8,600.00 | |
| *A Drawings* | | 8,600.00 |
| *To close.* | | |
| *B Capital* | 6,540.00 | |
| *B Drawings* | | 6,540.00 |
| *To close.* | | |
| *C Capital* | 8,540.00 | |
| *C Drawings* | | 8,540.00 |
| *To close.* | | |

A final trial balance of the ledger appears as shown in Fig. 132.

**The Firm A, B, C**

FINAL TRIAL BALANCE

**December 31, 19—**

| | | |
|---|---|---|
| *Cash* | 20,000.00 | |
| *Accounts Receivable* | 36,000.00 | |
| *Notes Receivable* | 4,000.00 | |
| *Machinery and Equipment* | 45,000.00 | |
| *Delivery Equipment* | 4,000.00 | |
| *Reserve for Depreciation—Machinery and Equipment* | | 24,500.00 |
| *Reserve for Depreciation—Delivery Equipment* | | 1,800.00 |
| *Reserve for Bad Debts* | | 2,680.00 |
| *Accounts Payable* | | 15,000.00 |
| *Accrued Expenses* | | 1,200.00 |
| *A Capital* | | 61,400.00 |
| *B Capital* | | 63,460.00 |
| *C Capital* | | 11,460.00 |
| *Merchandise Inventory, December 31, 19—* | 72,500.00 | |
| | 181,500.00 | 181,500.00 |

Fig. 132

**Interest Adjustments.** In the preceding illustration interest was charged on A's drawings in excess of $3,000.00. Any arrangement relative to interest on drawings is valid, providing it is agreed to by all of the partners. The purpose in allowing interest on invested capital at 6 per cent is to reward A and B for their investments in excess of C's investment. Without such an adjustment for interest on the investments, considerable inequality of treatment would result. In this illustration the interest is allowed on the amount of the investment at the beginning of the year. A somewhat more complicated situation arises when the interest is allowed on the average investment during the year. It is necessary in such event to compute the average investment by taking into consideration drawings.

**Admission of Partners.** Many problems arise in connection with the admission of new partners. In particular there occurs the problem of valuation, because if the firm has been successful it will have developed a considerable amount of goodwill, the value of which is not shown on the books. This is sometimes regarded as going concern value but for present purposes may be called goodwill.

To illustrate, suppose that A and B are in partnership and

that a simplified form of their balance sheet appears as shown in Fig. 133.

**A and B**

BALANCE SHEET

**as at December 31, 19—**

| | | | |
|---|---|---|---|
| Cash | $ 6,000.00 | Accounts Payable | $ 18,000.00 |
| Accounts Receivable | 15,000.00 | Mortgage | 5,000.00 |
| Merchandise | 25,000.00 | A Capital | 75,000.00 |
| Building | 70,000.00 | B Capital | 25,000.00 |
| Delivery Equipment | 4,000.00 | | |
| Furniture and Fixtures | 3,000.00 | | |
| | $123,000.00 | | $123,000.00 |

Fig. 133

The total net worth of A and B amounts to $100,000.00. Assume that for the year ending December 31, 19—, net profit amounted to $20,000.00 and that the results for preceding years indicate that there is every reason to believe that this splendid showing will be continued. C is being considered for admission to the firm. He has $20,000.00 cash to invest. It is evident that if A and B admit C as a partner without making any adjustment for goodwill on the balance sheet, they will be giving him the advantage of excess profits which they have managed to produce through their development of the goodwill of the business. It is reasonable to assume that this goodwill is worth at least $75,000.00, although it is a general rule in accounting that goodwill shall not be brought upon the books, except when purchased. There are a few exceptions to this rule. One exception is found in the present illustration. A and B would be justified in bringing goodwill upon the books at whatever they regard to be its value in order that they may show their net worth accounts proportionately increased. It is decided among A, B, and C that the goodwill shall be capitalized at $80,000.00 and that three-fourths of this amount shall be credited to A's Capital account and one-fourth to B's Capital account. The entry on the journal is as follows:

*December 31, 19—*

| | | |
|---|---|---|
| *Goodwill* | *80,000.00* | |
| *A Capital account* | | *60,000.00* |
| *B Capital account* | | *20,000.00* |
| *To bring goodwill on books preliminary to admission of C as partner.* | | |

The entry to admit C is as follows:

*December 31, 19–*

| | | |
|---|---|---|
| *Cash* | *20,000.00* | |
| *C Capital account* | | *20,000.00* |
| *To admit C as partner.* | | |

The balance sheet of the firm of A, B, and C now stands as shown in Fig. 134.

**A, B, and C**

BALANCE SHEET

**as at December 31, 19—**

| | | | |
|---|---|---|---|
| Cash | $ 26,000.00 | Accounts Payable | $ 18,000.00 |
| Accounts Receivable | 15,000.00 | Mortgage | 5,000.00 |
| Merchandise | 25,000.00 | A Capital | 135,000.00 |
| Building | 70,000.00 | B Capital | 45,000.00 |
| Delivery Equipment | 4,000.00 | C Capital | 20,000.00 |
| Furniture and Fixtures | 3,000.00 | | |
| Goodwill | 80,000.00 | | |
| | $223,000.00 | | $223,000.00 |

Fig. 134

The disposition of the goodwill must follow the agreement of the partners relative thereto. It may be permitted to stand on the books at $80,000.00, or it may be written off according to some predetermined plan. Obviously, the treatment to be accorded the goodwill in cases such as this should be considered before it is brought upon the books. If the goodwill of $80,000.00 were charged equally to the partners' Capital accounts, C's Capital account would show a deficit, which would hardly meet with C's approval. The goodwill might be written off in the profit and loss sharing ratio, assuming that the profit and loss sharing ratio agreed upon is A,5, B,2 and C,1. A's capital would be reduced to $85,000.00, B's to $25,000.00, and C's to $10,000.00. The entry to accomplish such a reduction of the goodwill would be as follows:

| | | |
|---|---|---|
| *A Capital* | *50,000.00* | |
| *B Capital* | *20,000.00* | |
| *C Capital* | *10,000.00* | |
| *Goodwill* | | *80,000.00* |
| *To write off goodwill in profit and loss sharing ratio, which is A,5, B,2 and C,1.* | | |

The variations in the conditions under which new partners may be admitted to an existing firm are innumerable, consequently, it is impossible to illustrate all of them. One additional case, however, may be considered.

Assume that A and B are partners, with investments of \$30,000.00 and \$20,000.00, respectively. C desires to invest a sum which will give him a one-third interest in the partnership. There are two possible solutions to this problem: (*a*) where the amount invested by C is retained in the business and (*b*) where it is paid proportionately to A and B.

*a*) If C invests his money in the business, the amount will be \$25,000.00 and the entry is as follows:

| | | |
|---|---|---|
| *Cash* | *25,000.00* | |
| *C Capital* | | *25,000.00* |
| *To admit C as a partner in the firm of A, B, and C, C securing a one-third interest in the firm.* | | |

*b*) In this case C will pay one-third of \$50,000.00, or \$16,666.66, to A and B. Of this amount A will receive \$10,000.00 and B \$6,666.66. The entry on the books is as follows:

| | | |
|---|---|---|
| *A Capital* | *10,000.00* | |
| *B Capital* | *6,666.66* | |
| *C Capital* | | *16,666.66* |
| *To give C a one-third interest in the firm of A, B, and C. C pays 10,000.00 to A personally and 6,666.66 to B personally.* | | |

**Incorporation of Partnerships.** The incorporation of either a sole proprietorship or a partnership need not involve any important change in the accounting records. As a rule, the capital stock of small corporations is closely held and no special records for capital stock are required. Of course, if the old records of the partnership are unsatisfactory it may be desirable to close the partnership books and open new books for the corporation; but this is not necessary if the books of the partnership are satisfactory. In incorporating, the laws of the state in which the incorporation is to be effected should be scrupulously observed. As a rule, there must be at least three incorporators. Consequently, if a sole proprietor desires to incorporate, he will find it necessary to secure two additional stockholders, usually relatives or associates, who must subscribe for one or more shares of stock each. If a partnership consists of two mem-

bers, they will find it necessary to secure an additional incorporator, who will be required to subscribe for at least one share of stock.

Since capital stock having a par value is denoted in round sums, such as $100.00 per share, or $50.00 per share, it may be necessary to make a slight adjustment in the partnership Capital accounts before transferring the capital stock of the corporation to the partners. To illustrate, assume that on the date of incorporation, the books having been closed, the capital accounts of A and B are as follows:

| | |
|---|---|
| *A Capital* | *7,943.21* |
| *B Capital* | *12,163.44* |

By paying $43.21 to A and $63.44 to B the capital accounts of the partners will be reduced to the following amounts:

| | |
|---|---|
| *A Capital* | *7,900.00* |
| *B Capital* | *12,100.00* |

If capital stock of a par value of $100.00 is authorized, A might now subscribe for 79 shares and B for 121 shares. The entry on the books required to show the conversion from a partnership to a corporation would be as follows:

| | | |
|---|---|---|
| *A Capital* | *7,900.00* | |
| *B Capital* | *12,100.00* | |
| *Capital Stock* | | *20,000.00* |
| *For incorporation of the firm of A and B as A and B, Incorporated, A receiving 79 shares of stock and B 121 shares.* | | |

**Partnership Dissolution.** Partnerships may be dissolved for any one of several reasons (see Chapter 15). When dissolution occurs it is necessary to liquidate the assets and pay the various claims against the firm. Creditors must be paid in the following order: (1) preferred, (2) fully secured, (3) partially secured, (4) unsecured.

After creditors are paid in full, loans from partners must be liquidated. Finally the investments of the partners must be repaid. Profits and losses incurred during the period of liquidation must be distributed in the usual profit and loss sharing ratio.

Sometimes but one payment to the partners need be made, but frequently it is necessary to pay the partners in two or more installments. In the latter event, the person in charge of liquidation must be careful not to overpay any partner.

*Case 1.* Assume that through a process of liquidation all liabilities of the firm of A and B have been liquidated and that a trial balance appears as follows:

**A and B**

TRIAL BALANCE

**July 31, 19—**

| | | |
|---|---|---|
| *Cash* | 100,000.00 | |
| *Deficit* | 30,000.00 | |
| *A Capital* | | 100,000.00 |
| *B Capital* | | 30,000.00 |
| | 130,000.00 | 130,000.00 |

Assuming that profits and losses are shared equally, the distribution of the deficit of $30,000.00 will result in the following trial balance.

**A and B**

TRIAL BALANCE

**July 31, 19—**

| | | |
|---|---|---|
| *Cash* | 100,000.00 | |
| *A Capital* | | 85,000.00 |
| *B Capital* | | 15,000.00 |
| | 100,000.00 | 100,000.00 |

The distribution of the cash is made as follows:

| | | |
|---|---|---|
| *A Capital* | 85,000.00 | |
| *B Capital* | 15,000.00 | |
| *Cash* | | 100,000.00 |
| *For first and final distribution to A and B.* | | |

It is sometimes desirable to tabulate the data relative to the distributions in order to show more clearly the facts involved. In Fig. 135 is shown such a tabulation of the data relative to the distribution to A and B.

**A and B**

DISTRIBUTION

| | A (50 per cent) | B (50 per cent) | Total |
|---|---|---|---|
| *Balance in Capital Accounts* | 100,000.00 | 30,000.00 | 130,000.00 |
| *First and final distribution* | | | 100,000.00 |
| *Loss apportioned* | 15,000.00 | 15,000.00 | 30,000.00 |
| *Distribution* | 85,000.00 | 15,000.00 | 100,000.00 |

Fig. 135

*Case 2.* This illustration differs from the preceding one in that three dividends are paid, that is, two interim dividends and one final dividend. Assume that after all debts are paid and profits and losses distributed, the trial balance of the firm of A, B, and C is as follows:

**A, B, and C**

TRIAL BALANCE

**November 30, 19—**

| | | |
|---|---|---|
| *Assets* | *400,000.00* | |
| *A Capital* | | *200,000.00* |
| *B Capital* | | *150,000.00* |
| *C Capital* | | *50,000.00* |
| | *400,000.00* | *400,000.00* |

Three liquidating dividends are paid as follows: $100,000.00, $150,000.00, $75,000.00.

The facts relative to the distribution are set forth in Fig. 136.

**A, B, and C**

DISTRIBUTION

| | A (33⅓ per cent) | B (33⅓ per cent) | C (33⅓ per cent) | Total |
|---|---|---|---|---|
| *Balance in Capital Accounts* | *200,000.00* | *150,000.00* | *50,000.00* | *400,000.00* |
| *First Distribution* | | | | *100,000.00* |
| *Possible Loss* | *100,000.00* | *100,000.00* | *100,000.00* | *300,000.00* |
| | *100,000.00* | *50,000.00* | *50,000.00** | |
| | *25,000.00** | *25,000.00** | *50,000.00* | |
| *First Distribution apportioned* | *75,000.00* | *25,000.00* | | *100,000.00* |
| *Balance* | *125,000.00* | *125,000.00* | *50,000.00* | *300,000.00* |
| *Second Distribution* | | | | *150,000.00* |
| *Possible Loss* | *50,000.00* | *50,000.00* | *50,000.00* | *150,000.00* |
| *Second Distribution apportioned* | *75,000.00* | *75,000.00* | | *150,000.00* |
| *Balance* | *50,000.00* | *50,000.00* | *50,000.00* | *150,000.00* |
| *Third Distribution* | | | | *75,000.00* |
| *Loss* | *25,000.00* | *25,000.00* | *25,000.00* | *75,000.00* |
| *Third Distribution apportioned* | *25,000.00* | *25,000.00* | *25,000.00* | *75,000.00* |

Fig. 136

In the foregoing tabulation, the possible loss after the first distribution is made is $300,000.00. When this is distributed equally

to A's, B's, and C's Capital accounts, there results a deficiency of $50,000.00 in C's Capital account. This must be borne equally by A and B as shown by the amounts followed by an asterisk (*). As a result of this distribution of C's deficit the first distribution is made $75,000.00 to A and $25,000.00 to B. Following the double ruling the balances of the accounts as reduced by the first distribution are shown and the same procedure is followed again. After the second distribution is effected the possible loss is $150,000.00. After this is distributed in the profit and loss sharing ratio, the second distribution is indicated, namely, $75,000.00 to A and $75,000.00 to B. In case of the third and final distribution, the actual loss of $75,000.00 is distributed equally and the third distribution is made $25,000.00 to each partner.

## *Chapter* 17

# THE VOUCHER SYSTEM

**Treatment of Purchases.** The treatment of purchases is an important consideration in any commercial or manufacturing enterprise. This is true for several reasons. In the first place, purchases represent one stage in the important cycle of circulation of capital. In other words, a large part of the capital of an enterprise must be used in making purchases and this process is consistently repeated.

In the second place, there arises the question of the transfer of title and, consequently, the prompt reflection of the resulting liabilities on the records. Some concerns pay promptly in order to secure all cash discounts. In such cases there is not likely to occur any great discrepancy, even though no record is made of purchases until cash is disbursed. Even then, however, there results a certain lag because there is always outstanding at least 10 days' purchases for which payment has not been made. This discrepancy would be serious at the close of the accounting period if the cash basis of accounting were adhered to, since it would result in the omission of all liabilities on recent purchases not yet paid for.

In the third place, omitting to make entries for purchases for as long a period as 10 or 12 days means that although title has been taken for the goods bought and the corresponding liability thereof is acknowledged, the information relative to such purchases is kept in the form of memoranda. This is obviously unsystematic and is likely to lead to errors and discrepancies.

One plan of avoiding these errors is to operate a purchases journal in which entries are made debiting Purchases account and crediting the individual or concern from whom the purchase is made. This results in showing all liabilities incurred to date and therefore insures accuracy in the balance sheet and income statement of the accounting period, because credits are correctly ex-

pressed, and in the inventory of merchandise are included all items of purchases for which a corresponding liability is shown.

It should be noted, however, that the word *purchases* as used here is limited strictly to purchases of merchandise in case of commercial establishments and to raw materials in case of manufacturing enterprises. In fact, this word might be extended to cover practically all expenditures. For example, using the word in a broader sense, it may be said that advertising, repairs, and labor are purchases. There is no reason why purchases of merchandise or raw materials should be given essentially different treatment from purchases of repairs, advertising, labor, and other items. The desirability of standard and uniform procedure in connection with all expenditures requiring the disbursement of cash is evident. This uniformity of procedure is secured through the operation of what is known as the *voucher system.*

The voucher system is found in various forms and, of course, must be adapted to the needs of the enterprise in question. Essentially, however, the voucher system may be said to be a uniform method of treating all types of purchases, not only purchases of merchandise or raw materials, but purchases of advertising, rent, repairs, labor, salaries, fixed assets, delivery equipment—in fact, all items of expenditure for which disbursements of cash must be made. It is evident that where the voucher system is used the purchases journal must be radically revised, since many special columns are required to record the wide variety of purchases which must be made. In fact, the procedure involved when the voucher system is installed consists in abandoning the purchases journal and using in its place a record which is known as a voucher register. This contains whatever special columns the needs of the concern in question dictate. Thus, a concern engaged in the retail hardware business would require in the voucher register columns for purchases, advertising, clerical help, salaries, as well as a miscellaneous column. A concern engaged in manufacturing would require columns for raw materials purchases, factory expense, factory labor, selling expense, administrative expense, advertising, salaries, and a sundries column, as well as such other columns as special circumstances might require. In any event, there must be a column in which every

item is entered in order that the credit or liability side of each transaction may be recorded. Every entry in the voucher register is essentially a journal entry in which the debit is recorded in one or more debit columns, such as the Advertising column, or the Purchases column, and the credit is invariably recorded in a Credit column known as the Voucher Payable column. In other words, there must be several or many debit columns in the voucher register and but one, or at the most, two credit columns. The essential credit column is, as already stated, the Voucher Payable column, but in addition to this there may be a credit column in which are recorded discounts on purchases.

The method of operation of these columns will be made clear in the illustrations which follow in this chapter.

**The Voucher.** The word *voucher* possesses a variety of meanings. *The Century Dictionary* defines the word as follows: "One who or that which vouches, as for something; a book, document, stamp, or the like which serves to prove the truth of something; specif., a receipt or other written evidence, as of the payment of money."

Illustrations of vouchers are found in checks, notes, and many other forms of commercial paper. Any document which tends to substantiate the validity or character of a transaction may be regarded as a voucher. In the narrow technical sense in which the word is used in this chapter, it refers to a highly specialized business form which performs an important function in connection with the operation of the voucher system. It may be said to be a form on which are shown all of the essential facts relative to any purchase which will require the disbursement of cash and which, therefore, may be used as a basis for an entry in the voucher register.

The essential information for the filling out of the voucher is usually secured from the invoice received from the person or concern from whom the purchase is made. Thus, if a purchase of certain raw materials has been made, the invoice received from the seller of the raw materials will indicate the quantity and amount together with the terms of the sale. If a purchase of merchandise has been made, similar facts will be shown on the invoice received from the seller of the merchandise. If the purchase takes the form of an auto delivery truck to be used in the business, the essential facts will

Voucher No ______ Date ______

Check No ______ Terms ______

Name of Payee ______

Address of Payee ______

| Description | Unit Price | Totals |
|---|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |

Approved for Payment

Entered in Voucher Register

______ President

______ Accountant

Fig 137

| Summary | Account Distribution |
|---|---|
| Voucher No.________ | Raw Materials |
| Date Issued________ | Labor—Direct |
| To Whom________ | Labor—Indirect |
| Address________ | Office Expense |
| Amount________ | Factory Expense |
| Terms________ | Selling Expense |
| Date Paid________ | Repairs |
| Check No.________ | Power |
| Discount________ | Heat and Light |
| | Sundries |
| | ________ |
| | ________ |
| | ________ |
| | ________ |
| | ________ |
| | Total |

Fig 138

likewise be shown on the invoice received from the auto dealer. If the purchase takes the form of repairs made by an outside contractor, the invoice received from him will indicate the nature of the repair and the amount to be paid. In case of labor and salaries, however, an invoice will not be received but the essential facts will be obtained from the payroll records. Given the facts in any particular transaction, which requires the disbursement of cash, the voucher will be made out after the invoice or other supporting document has been properly audited. In other words, all invoices are either audited or unaudited invoices. The audit of an invoice consists in checking it as to (*a*) quantity, (*b*) receipt of goods, (*c*) accuracy of extensions and additions, (*d*) terms of payment, and (*e*) distribution of resulting charges, that is, what accounts are to be charged when the invoice is entered in the voucher register.

The fact that the invoice has been checked as to quantity, accuracy, etc., should appear definitely on the face of the invoice. It is then ready to be vouchered by transferring the essential information from the invoice to the voucher form. After this has been done, the invoice may be attached to the voucher; and after the essential information shown on the voucher has been entered on the voucher register, the voucher with attached invoice should be filed according to date of payment in an unpaid voucher's file. Later, after the voucher has been paid, it should be filed either according to alphabetical arrangement or in serial order. These audited vouchers are likely to accumulate in large quantities and considerable filing space may be required for them since they should be preserved for a long period of years. Before entry of the voucher in the voucher register is made, the voucher also should be audited by being checked as to all essential details, such as unit price, quantities, extensions and additions, as well as the account or accounts to be charged. In Fig. 137 is shown the face of a voucher and in Fig. 138 is shown the reverse side of the same form.

The student should examine these forms of the voucher and note the use of each space. For example, in Fig. 137 the number of the voucher appears at the top and under the voucher number appears space for the check number. Vouchers as well as checks are numbered consecutively, but this does not mean that the voucher

number will be the same as the check number. Sometimes vouchers are not paid in the order in which they are numbered. Thus, number 210 might be the voucher number and the check number might be 214. The date is the date on which the voucher is prepared. The terms are those indicated in the voucher, such as 2/10, n/30 or 2/10, n/60. The payee's name and address should be entered in the space provided. The Description column is to be used for as much detail as is necessary to specifically indicate the character of the purchase. In the Unit Price column should appear whatever the price per unit is, as, for example, $2.00 per barrel. In the Totals column should be extended the amounts secured by multiplying the unit price by the number of items. The *Approved for Payment* space should be signed by the proper official. In the illustration this is the president. The accountant or bookkeeper should sign in the *Entered in Voucher Register* space.

On the reverse side of the voucher appears the account distribution. This in some cases may be much more detailed than is shown in the illustration. Opposite each item to which a charge is made should appear the amount. For example, on the same voucher might be a charge of $2,000.00 to direct labor and $1,000.00 to indirect labor. On the voucher there might be a charge to *Power*. If the account to be charged is not indicated, it should be written in the blank space under *Sundries*. The total of the account distribution should, of course, agree with the amount shown on the reverse side of the voucher. Under *Summary* is given what is in effect a summary of the entire voucher, as a reading of the items beginning with *Voucher No.* and ending with *Discounts* shows. In Fig. 139 is shown a form of voucher with all information on one face.

**Voucher Register.** The voucher is used as a basis for the entry to be made in the voucher register. The voucher register, as already explained, is an expansion of the purchases journal so arranged as to permit entering all types of purchases which necessitate the disbursement of cash. It therefore displaces the purchases journal but does not displace the general journal, which remains available for adjusting and closing entries, as well as entries in which no cash transaction is involved. The voucher register practically displaces the cash payments book, since the distribution ordinarily made in

## VOUCHER WITH ALL INFORMATION ON ONE FACE

Month of.......... 19.... No....

To..............................

..............................

..............................

**ACCOUNTS PAYABLE VOUCHER**

No...........

| STATEMENT OF ACCOUNT | | | DISTRIBUTION (Dr.) | | |
|---|---|---|---|---|---|
| Date | Description | Amount | Account | Detail | Amount |
| | | | | | |
| | TOTAL Cr. Accts. Payable | | | | |

| APPROVED AND POSTED | How Paid | | | | |
|---|---|---|---|---|---|
| | Date | Check No. | Amount | Discount | Net Amount of Check |
| Prepared By | | | | | |
| Entered V. R. | | | | | |
| Distribution O. K. | | | | | |
| Approved by | | | | | |
| Approved by | | | | | |

Fig. 139

the cash payments book is made in the voucher register. In place of the cash payments book, however, it is necessary to operate a check register, which provides a systematic record of all checks drawn and serves as a posting medium, as will be explained.

The voucher register must be designed to fulfill the requirements of the business in question. The columns and column headings must conform to the classification of accounts in effect. The size of the business and the volume of the transactions must also be considered. In a large concern it may be impossible to provide as many columns as the classification of accounts would indicate to be necessary so that coding may be resorted to. That is, in a given column, such as the factory expense column, many different kinds of factory expense items may be listed and designated by distinguishing numbers so that at any time an analysis may be made of the total of this column. Other columns may be coded in the same manner. In Fig. 140 is shown a form of voucher register.

Referring to Fig. 140, the reader should study the treatment of each voucher entered therein. The first voucher is number 15. The distribution of this voucher may be expressed in journal entry form as follows:

| | | |
|---|---|---|
| *Raw Materials* | *350.50* | |
| *Merchandise Purchases* | *250.00* | |
| *Vouchers Payable* | | *600.50* |

The postings are not made from the voucher register, however, until the end of the month, when the columns are totaled and the totals posted. The page of the ledger to which each total is posted is written in above the total in the voucher register. The Sundry Accounts column cannot be treated in this way because each item must be posted separately, the page number of the ledger being entered in the L. F. column. The posting of the voucher register shown in Fig. 140 may be expressed in journal entry form as follows:

| | | |
|---|---|---|
| *Raw Materials* | *350.50* | |
| *Merchandise Purchases* | *250.00* | |
| *Wages* | *600.00* | |
| *Office Salaries* | *550.00* | |
| *Advertising* | *50.00* | |
| *Furniture and Fixtures* | *65.00* | |
| *Vouchers Payable* | | *1,865.50* |

## VOUCHER REGISTER

| Voucher No. | Date 19— | | Creditor | Terms | Vouchers Payable, Cr. | Debits: Raw Materials | Debits: Merchandise Purchases |
|---|---|---|---|---|---|---|---|
| 15 | Feb. | 3 | James Mfg. Co. | 2/10, n30 | 600 50 | 350 50 | 250 00 |
| 16 | | 8 | Crandell Avt. Co | | 50 00 | | |
| 17 | | 14 | Payroll | | 575 00 | | |
| 18 | | 20 | Nichols Furn. Co. | n30 | 65 00 | | |
| 19 | | 28 | Payroll | | 575 00 | | |
| | | | | | L. 35 1,865 50 | L. 15 350 00 | L. 14 250 00 |

Fig. 140

## VOUCHER REGISTER

| DEBITS | | | | | | | | Payment | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Wages | Office Salaries | Advertising | Repairs | Miscellaneous Expense | Sundry Accounts | | | Date | Check No. | Unpaid Vouchers |
| | | | | | Amount | Account | L. F. | | | |
| | | | | | | | | 2/20 | 62 | |
| | | 50.00 | | | | | | 2/17 | 61 | |
| 300.00 | 275.00 | | | | | | | 2/14 | 60 | |
| | | | | | 65.00 | *Furniture and Fixtures.* | 21 | | | 65.00 |
| 300.00 | 275.00 | | | | | | | 2/28 | 63 | |
| L. 25 600.00 | L. 22 550.00 | L. 26 50.00 | | | 65.00 | | | | | 65.00 |

Fig. 140

It should be emphasized that no entries in the journal, such as those above, are required since the postings are made direct from the voucher register. The illustrative entries above are shown merely to indicate how equality of debits and credits is secured in the voucher register.

As has already been stated, it may be desirable to code one or more columns in the voucher register because it is impossible to provide separate columns for all accounts falling within a certain class of expenses. For example, in case of a manufacturing enterprise it might be desirable to code manufacturing expenses. In order to show how such coding is accomplished, the right-hand page shown in Fig. 140 is revised in Fig. 141 to make possible the coding of manufacturing expenses.

By referring to the Manufacturing Expense column, it will be noted that account number 440 is charged once, account number 441 twice, or for the total of $85,000.00, etc. In connection with the coded column, it is necessary to use an analysis sheet in order to determine the amount charged to each account number. The postings are made from the analysis sheet in order that each account may be charged for the proper amount. In connection with the voucher register form shown in Fig. 141, three analysis sheets would be needed—one for manufacturing expense, one for selling expense, and one for administrative expense. Assuming that there are seven accounts included in each of these three divisions it is evident the three-column headings in the voucher register provide for 21 different accounts. A study of Fig. 142 will indicate the manner in which the analysis sheet is employed.

**The Voucher Check.** Payment on a given voucher must be made by issuing a check for the amount shown in the Voucher Payable column for the voucher in question. The function of such check is usually threefold: (1) to afford certain information to the payee, such as date of vendor's invoice and vendee's voucher number; (2) to pay the debt; (3) to serve as a receipt for payment. The number of the check should be entered on the voucher and in the voucher register. This indicates exactly how each voucher is paid. The number of the voucher may be entered on the check at the time the check is made out, but this is not done by all companies.

**VOUCHER REGISTER**

**ILLUSTRATING USE OF CODE NUMBERS**

| Raw Materials, Dr. | Code No. | Manufacturing Expense, Dr. | Code No. | Selling Expense, Dr. | Code No. | Administrative Expense, Dr | Payroll | Sundry Accounts, Dr. | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Account | Fol. | Amount |
| | 440 | 200,000 00 | | | | | | | | |
| | 441 | 75,000 00 | | | | | | | | |
| | 442 | 50,000 00 | | | | | | | | |
| | 443 | 60,000 00 | | | | | | | | |
| | 444 | 40,000 00 | | | | | | | | |
| | 446 | 15,000 00 | | | | | | | | |
| | 447 | 300 00 | | | | | | | | |
| | 446 | 400 00 | | | | | | | | |
| | 441 | 10,000 00 | | | | | | | | |

Fig. 141

Sheet No. 1

## ANALYSIS SHEET

Account: Mfg. Expense

Period: July, 19—

| Total | C. No. 440 | C. No. 441 | C. No. 442 | C. No. 443 | C. No. 444 | C. No 445 | C. No. 446 | C. No. 447 | |
|---|---|---|---|---|---|---|---|---|---|
| | Indirect Labor | Factory Supplies | Heating | Lighting | Repairs | Misc. Tools | Inspection | Telephone | |
| | *200,000.00* | *75,000.00*<br>*10,000.00* | *50,000.00* | *60,000.00* | *40,000.00* | | *15,000.00*<br>*400.00* | *300.00* | |
| *450,700.00* | *200,000.00*<br>*L 32* | *85,000.00*<br>*L. 32* | *50,000.00*<br>*L. 33* | *60,000.00*<br>*L. 34* | *40,000 00*<br>*L. 34* | | *15,400.00*<br>*L. 35* | *300.00*<br>*L. 35* | |
| | | | | | | | | | |

There are four possible types of checks which may be used in connection with the voucher system: (1) ordinary check with which is mailed a copy of the voucher, (2) single form voucher check, (3) ordinary check with detachable information, (4) folder voucher check.

When the voucher is mailed with an ordinary check, the purpose is to furnish to the payee certain information which will help him to recall the transaction and to enable him to make a check-up to see that the payment is of correct amount and otherwise as the vendee claims. Such a voucher should also serve as a receipt, since the payee is expected to sign it and return it to the vendee. Here, however, difficulty may arise because in some cases the vendor will not take the trouble to sign and return the voucher. For this reason the vendee always should make out such a voucher in duplicate. Owing to the disadvantages which attach to the sending of the original voucher accompanied by an ordinary check, the plan has been abandoned to a large extent.

Under the second plan listed above, there appears on the face of the check a small space in which may be written the distribution of the charges and other information. This information is transferred to the check from the voucher. This is not satisfactory if the information to be shown on the check is detailed. In general, however, the plan is good, especially since the size and simplicity of the check make it convenient to handle.

Under the third plan suggested, the voucher or data derived from the voucher is attached to the check in detachable form. The payee detaches this section from the check and keeps it.

The fourth plan makes use of the folder voucher check. The face of this check, before folding, comprises the check and a space for indorsements. The voucher is on the back of the check. When the check is folded, the voucher is on the inside and the check is on one face of the outside. The space for indorsement is on the other outside face. No part of this type of check is detachable. The only disadvantage in this type of voucher check is that it is somewhat unwieldy to handle. In Fig. 143 is shown the single form of a voucher check. In Fig. 144 is shown a check with detachable information. In Fig. 145A is shown the face of a folder voucher check, and in Fig. 145B is shown the back of the folder voucher check.

SINGLE FORM VOUCHER CHECK

WINEGOR-GARMAN LUMBER CO.
39 SOUTH LA SALLE STREET

No. 14305

CHICAGO, ____________

PAY TO THE ORDER OF **STATE BANK OF CHICAGO**

______________________________ $ ________

WINEGOR-GARMAN LUMBER CO.

____________________
GENERAL MANAGER

THIS CHECK IN FULL PAYMENT OF FOLLOWING

| DATE | INVOICE AMOUNT | FREIGHT | DISC T ETC | NET |
|---|---|---|---|---|
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

Fig. 143

**CHECK WITH DETACHABLE INFORMATION**
**(Made Out in Duplicate)**

## SUBSIDIARY COMPANIES OF YANKEE STEEL CORPORATION

No.

| Our Voucher No. | Vendor's Invoice Date | Vendor's Invoice Amount | Memoranda | Deductions Misc. | Deductions Transpor. | Deductions Discounts | Net Amount |
|---|---|---|---|---|---|---|---|

Approved for Payment
Comptroller or Ass't Comptroller

Less Contra
Balance

This Statement To Be Detached from Check and Retained by Payee

The endorsement on the back hereof is an acknowledgment of payment in full of account as stated above. NO OTHER RECEIPT IS REQUIRED

HOMEWOOD, PA.

Treas. No.

PAY TO THE ORDER OF

SUBSIDIARY COMPANIES OF YANKEE STEEL CORPORATION

Ass't Treas.

Fig 144

INDORSEMENTS

DO NOT
DETACH

THIS VOUCHER CHECK IS
ISSUED IN FULL PAYMENT OF
THE WITHIN ACCOUNT AND
THE PAYEE ACCEPTS IT AS
SUCH BY THE INDORSEMENT
ABOVE

**GRAIN HARVESTER COMPANY**

Chicago, Ill.__________ Treas. No.______

Pay to the
Order of ____________________ $______

____________________

Grain Harvester Co.

Countersigned

______________ ______________

Auditor of Disbursements For Treasurer

**[Made Out in Duplicate]**

Fig 145A

**BACK OF FOLDER VOUCHER CHECK**
**[Made Out in Duplicate]**

**Grain Harvester Company**

19 Voucher No.__________

| | | | | | |
|---|---|---|---|---|---|
| | | Account<br>WORKS | | | |

Checked By__________ DUPLICATE

Fig. 145B

**Treatment of Cash.** The use of a voucher system has no effect upon the method of treating cash receipts. On the other hand, the cash disbursements journal is entirely changed. Under the voucher system it is preferable to make the cash receipts journal and the cash disbursements journal two entirely separate books, each, of course, handled by a different person.

The cash disbursements journal becomes what is usually called the check register, a relatively simple record. This is because most of the columns ordinarily found in the cash disbursements journal are transferred to the voucher register where the distribution of the charges is made. In effect, the cash disbursements journal becomes a register of checks. A form of a check register is shown in Fig. 146.

The columns in the check register are as follows: (1) date, (2) name of payee, (3) check number, (4) voucher number, (5) voucher payable, dr., (6) bank, cr. If checks are drawn on more than one bank, there should appear a column for each bank. The only columns that are posted are the Voucher Payable, Dr., and the Bank, Cr., columns. The page in the general ledger to which the postings are made is written in above the totals in the check register.

**Check Register**

| Date | | Name of Payee | Check Number | Voucher Number | Vouchers Payable Dr | | Bank Cr. | |
|---|---|---|---|---|---|---|---|---|
| *19—* | | | | | | | | |
| *Feb.* | *14* | *Payroll* . | *60* | *17* | *575* | *00* | *575* | *00* |
| | *17* | *Grandell Advt. Co* . . | *61* | *16* | *50* | *00* | *50* | *00* |
| | *20* | *James Mfg. Co* | *62* | *15* | *600* | *00* | *600* | *00* |
| | *28* | *Payroll* . . . . | *63* | *19* | *575* | *00* | *575* | *00* |
| | | | | | *(5)* | | *(10)* | |
| | | | | | *1,800* | *00* | *1,800* | *00* |

Fig. 146

**Use of Accounts Payable Ledger.** One of the reputed advantages of the voucher system is the possibility of eliminating the use of the creditors or accounts payable ledger. In some cases this is an undoubted advantage, but not always, owing to the following considerations: (1) Where no accounts payable ledger is kept, the amount of business done with each creditor is not readily ascertain-

able. (2) The work of referring to past transactions may be increased rather than decreased by the elimination of the accounts payable ledger.

However, it is possible to maintain an accounts payable ledger when the voucher system is used. Accounts with creditors may be kept in a subordinate ledger, postings being made to these accounts from the voucher register and from the check register. Credits are posted from the Vouchers Payable column in the voucher register, and debits are posted from the Vouchers Payable column in the check register. Vouchers prepared for payroll, expenses, and other accounts not affecting creditors need not be posted to the accounts payable ledger. If they are not posted, the accounts payable ledger will contain only true accounts payable, but the sum of the balances of the accounts payable accounts will not agree with the total of the unpaid vouchers, as shown in the Vouchers Payable account in the general ledger. This is because the latter account comprises all cash disbursement items, not simply those pertaining to creditors.

The accounts payable ledger may be made to agree with the Voucher Payable account by carrying in the accounts payable ledger an account for *Miscellaneous Items*. Items other than true accounts payable items will be posted to the credit of this account from the voucher register and to the debit of the account from the check register.

Where it is not desirable to operate an accounts payable ledger, it is possible to maintain an index of creditors. This is usually in card form, one card being filled out for each creditor. Each card when filled in to date shows the voucher numbers relating to all transactions with the creditor in question. These voucher numbers may be used as a basis of reference should additional information to be found in the voucher register be desired at any time. The cards should be arranged in alphabetical order and filed for reference.

**Special Considerations.** The voucher system should not be installed without first giving consideration to certain matters which may render its operation difficult or impossible. These will be briefly treated under the following heads: (1) discounts on purchases, (2) partial payments, (3) purchase returns and allowances, (4) notes payable.

*7. Discounts on Purchases.* Nearly every concern takes some of the cash discounts that are available, and some enterprises are able to take all cash discounts. The treatment of cash discounts on purchases can be accomplished satisfactorily in connection with the use of the voucher system if it is known in advance what policy is to be pursued with reference to cash disbursements. If it is known that the enterprise will be able to take all cash discounts, there should appear in the voucher register immediately following the Voucher Payable, Cr., column a Purchases Discount, Cr., column. To illustrate the procedure, assume that the invoice price is $400.00 and the cash discount is $8.00. With the voucher register ruled, as indicated above, the entry therein expressed in journal form is:

| | | |
|---|---|---|
| *Purchases* | *400.00* | |
| *Voucher Payable* | | *392.00* |
| *Purchases Discounts* | | *8.00* |

When this item is paid, the entry in the check register expressed in journal form is:

| | | |
|---|---|---|
| *Vouchers Payable* | *392.00* | |
| *Cash* | | *392.00* |

Next, assume that the concern may not be able always to take the cash discount. In this event the Purchases Discount column should appear not in the voucher register but in the check register. The voucher invariably will be made out for the full amount of the invoice. Taking the same illustration as was used above, the entry in the voucher register expressed in journal form is:

| | | |
|---|---|---|
| *Purchases* | *400.00* | |
| *Vouchers Payable* | | *400.00* |

If, when payment is made, it is possible to secure the discount, the entry in the check register expressed in journal form is:

| | | |
|---|---|---|
| *Vouchers Payable* | *400.00* | |
| *Cash* | | *392.00* |
| *Discount on Purchases* | | *8.00* |

If, however, the concern is unable to pay in time to secure the discount, the entry in the check register expressed in journal form is:

| | | |
|---|---|---|
| *Vouchers Payable* | *400.00* | |
| *Cash* | | *400.00* |

*2. Partial Payments.* Under the voucher system each voucher may be said to be a unit, since it is filled out to cover a definite debt which is to be paid. A partial payment of the voucher would result in much confusion, so it must be paid in full. The only way in which partial payments may be treated satisfactorily under the voucher system is to know in advance what the amount of each payment is so that a separate voucher may be made out for each payment. Thus, if there are to be two payments, one voucher represents the first payment and another the balance. If a single voucher has already been made out and it is decided to make a partial payment, the original voucher must be cancelled and the entry therefor in the voucher register crossed out. The *original voucher* should of course be preserved in the *paid vouchers* file. The number of the new vouchers used in place of the original voucher should be entered in the Manner of Payment column for the original voucher. If partial payments are extensively used, it may be desirable to avoid the use of the voucher system.

*3. Purchase Returns and Allowances.* If there are many purchase returns and allowances, the voucher system may be found to be impracticable. The solution may be found, however, in a check of all returns and allowances before it is necessary to make out the voucher. When this can be done, the voucher is made out for the net amount and no difficulty arises. It is highly important therefore that all goods should be received and checked carefully before the voucher is made out. Unfortunately, there may be some returns and allowances which cannot be discovered in this process. When such items occur, one of two possible procedures may be followed, namely: (1) write the amount of the purchase return and allowance in the vouchers register in red ink, or (2) make an entry in the general journal and then issue a new voucher.

When the red ink method is used, the entry must be made in small figures in red ink on the same line of the voucher register in which the affected voucher is entered, but above the amounts in the Voucher Payable, Cr., and Purchases, Dr. (or other debit) columns. The red figures represent deductions from the black figures and only the difference should be included in the totals of the columns.

When the journal entry method is followed, the old voucher must be cancelled and a new one made out. The cancellation of the old voucher is effected by the journal entry as follows:

| | | |
|---|---|---|
| *Vouchers Payable* | *400.00* | |
| *Vouchers Payable* | | *375 00* |
| *Purchase Returns and Allowances* | | *25 00* |
| *To issue voucher number 269 and to cancel voucher number 260, because of returns and allowances on goods* | | |

The new voucher for $375.00 must be entered in the Sundry column in the voucher register and must be debited to Vouchers Payable instead of to *Purchases*. The net effect of the whole procedure may be expressed as follows:

| | | |
|---|---|---|
| *Purchases* | *400 00* | |
| *Vouchers Payable* | | *375.00* |
| *Purchase Returns and Allowances* | | *25 00* |

This method is somewhat more complicated than is the red ink method but keeps the books in neater condition.

4. *Notes Payable.* The liabilities created by the issuing of notes should be shown under the title of *Notes Payable*. When, however, a note is paid, a voucher must be prepared authorizing the payment. Of course, such a voucher should not be used until the date of maturity of the note in question arises. Expressed in journal form the entry in the voucher register is:

| | | |
|---|---|---|
| *Notes Payable* | *600.00* | |
| *Vouchers Payable* | | *600 00* |

In the check register the entry is:

| | | |
|---|---|---|
| *Vouchers Payable* | *600.00* | |
| *Cash* | | *600 00* |

Thus, the debit to Vouchers Payable account in the check register offsets the credit to Vouchers Payable account in the voucher register.

# *Chapter* 18

# MANUFACTURING ACCOUNTING

**The Problem of Cost.** The concept of *cost* is one of basic importance to every student interested in the principles of accounting. Although it frequently is thought of as being limited to discussions of cost accounting, this is not the truth. The concept of cost is applicable to all processes of accounting. Cost is just as important to the merchandise wholesaler or retailer as it is to the manufacturer. The only difference is the manner in which cost must be computed. In some instances, cost is a relatively simple concept. In other cases, it is highly complex.

A retail dealer engaged in the sale of merchandise is apt to think of cost, as applied to the merchandise which he sells, as the invoice price of the goods which he purchases from wholesalers and middlemen. Reflection shows, however, that this is not the case. Cost to the retailer is more complicated than this. It includes not only the invoice price of the goods but also transportation costs, insurance during its transportation, as well as insurance and other storage costs after the goods are received.

In manufacturing, the concept of cost is even more complicated. This is because of the processes through which raw materials must go before they are ready for sale in the form of finished goods. The raw material costs include practically all costs applicable to merchandise purchased by the retailer, but after raw material costs are ascertained it is necessary to compute the costs involved in the manufacturing process. The necessity of accurate unit costs in this respect has given rise to an important science, namely, that of cost accounting. This science of cost accounting will not be explained in this book. It will be necessary to limit the discussion of cost and manufacturing to general or yearly costs. When such total costs for a month or a year are secured, unit costs of reasonable dependability can be computed only where the output is homogeneous, that

is, each unit like other units. Thus, if a concern manufactures one type of piano, total yearly manufacturing costs divided by the number of pianos manufactured gives the cost per piano. If, however, a concern manufactures pianos of various models, some much more costly than others, it is evident that the cost per piano cannot be obtained by the simple method described above.

**Elements of Cost.** It is now in order to state more fully what are the elements of cost in manufacturing. These may be first listed and then explained. They are as follows: (1) direct materials, (2) direct labor, (3) overhead.

*1. Direct Materials.* Direct materials comprise all physical materials which enter into the composition of the manufactured product. Excluded from the category of direct materials are all materials consumed in the manufacturing process but which do not enter into the construction of the article produced. The oil used to lubricate machines comes under the head of supplies or indirect materials, since it does not become a part of the structure of the output. All of the materials of this sort are usually carried in an account entitled *Supplies or Factory Supplies*, as it is important to distinguish them from other items of supplies, such as *Office Supplies.*

Direct materials must be purchased with a view to the needs of the manufacturing processes. Naturally, a concern must first determine what type of output it wishes to produce in view of its facilities and the demands of the market. In other words, it must prepare a kind of budget of articles to be manufactured. It then purchases raw materials most suitable for the construction of these articles and at the best price obtainable. The chief element of cost of direct raw materials is the price paid for them, but accuracy demands that certain other elements of cost be added to the purchase price, such as transportation inwards, insurance, and storage costs. Typical illustrations of raw materials are as follows:

*a*) In the case of a furniture manufacturing plant, direct materials consist of lumber, glue, paints, varnishes, screws, nails, upholstering material, etc. Indirect materials in the same type of plant would comprise sandpaper, oil for lubricating machines, pumice stone for polishing, etc.

*b*) In the case of a concern engaged in the manufacture of hats, direct raw materials should consist of furs and ribbons for felt hats, straw or other light materials for summer hats, leather for hat bands, thread, etc. Indirect materials would be such items as cleaning materials and lubricating oils.

*c*) In case of an oil refinery, direct raw materials comprise the various kinds of crude petroleum. Indirect materials comprise certain chemicals used in the refining processes, as well as lubricating oils, cleaning materials, etc.

2. *Direct Labor*. Direct labor is labor applied in such a way that it can be accounted for as a part of the cost of a unit of output. It is in contrast with *indirect labor* which, being a part of overhead cost, is considered below under that topic.

Suppose, for purposes of illustration, a furniture manufacturing concern is manufacturing office desks. The direct material involved consists of lumber, glue, screws, nails, and varnish or lacquer. The direct labor is that labor which is definitely expended in connection with the manufacture of the desks. Thus the labor required to saw the lumber, to smooth it, to fasten it together in the form of a desk, to polish and varnish it, is direct labor. It is evident, however, that these processes of manufacture could not be carried on if certain expenditures were not made for indirect labor. Examples of the latter are janitor services, repairs to machines, and labor necessary to keep the factory in efficient operating condition.

Direct labor sometimes comprises a large part of total cost. This is especially true where much hand work or so-called bench work is required. Direct labor is reduced to a minimum where highly standardized products can be made on machines which can be operated at a relatively small cost for labor.

Suppose that a factory has received an order for an especially designed piece of furniture. In such a case, large expenditures for skilled direct labor are required.

3. *Overhead Cost*. Overhead cost includes all manufacturing costs other than direct materials and direct labor. It is sometimes termed *oncost* or *manufacturing overhead expense*. However, overhead cost appears to be the more suitable expression. Illustrations of overhead cost are as follows: (*a*) indirect labor, (*b*) power, (*c*) heat and light,

(*d*) supervision, (*e*) insurance, (*f*) depreciation, (*g*) miscellaneous factory expenses.

It is not necessary to enter into a detailed discussion of overhead costs. It is necessary, however, that each enterprise, engaged in manufacturing, carefully account for all elements of overhead cost.

A brief description of each of the items listed above as elements of overhead cost will aid the student to secure a better understanding of this important matter.

*a*) Indirect labor is all labor which cannot be regarded as being directly applicable to a unit of output. As in the case of all other elements of overhead costs, indirect labor must be applied to output by allocating or distributing it on some arbitrary basis. By arbitrary basis is meant some plan of distributing overhead cost to output without any serious inaccuracy. For example, if indirect labor is distributed to output proportionately to direct labor, such distribution is said to be made on an arbitrary basis. To illustrate, suppose that in a given month three machines are constructed at a direct labor cost of $7,000.00, $2,000.00, and $1,000.00. Assume further that indirect labor for the month amounts to $1,000.00. If the distribution of the indirect labor is made on the basis of direct labor cost, the facts relative to direct labor costs and indirect labor costs may be stated thus:

| | Direct Labor Cost | Indirect Labor Cost |
|---|---|---|
| *Machine Number 1* | *7,000.00* | *700.00* |
| *Machine Number 2* | *2,000.00* | *200.00* |
| *Machine Number 3* | *1,000.00* | *100.00* |

*b*) Power is needed to drive machinery. Sometimes its application is such that it can be treated as direct cost, but this is not usually the case.

*c*) Heat and light must be treated ordinarily as indirect cost because of the impossiblity of allocating this item on any other than an arbitrary basis.

*d*) Supervision includes the services of foremen and factory managers. Since their attention is naturally shifted from one job to

another and frequently is not applicable to any particular work, the cost of such supervision must be treated as overhead cost.

*e*) Insurance here refers to insurance on factory, equipment, and buildings. This obviously is an element of overhead cost.

*f*) Depreciation, as applied to cost of manufacturing, includes depreciation of factory, buildings, machinery, and equipment. Unfortunately this important element of manufacturing cost is neglected frequently or treated in an unscientific manner. It is as much a cost of production as is labor or material. Because of its character it ordinarily must be accounted for as overhead cost.

*g*) Miscellaneous factory expenses. Under this head must be included all items of manufacturing cost which are not sufficiently important to make it worth while to keep separate accounts for them. The miscellaneous character of such an account obviously renders it impossible to distribute this item of cost on any other than an arbitrary basis; hence it must be regarded as overhead cost.

**Inventories.** The nature of any manufacturing undertaking is such that three important kinds of inventories are essential to the carrying out of the work. The importance of correct accounting for inventories already has been explained in connection with the accounting for merchandising enterprises. If all goods purchased during a given period could be sold during that period, there would be no inventory at the close of the period and hence no inventory at the opening of the following period; and the total purchases in a given period would represent the cost of goods sold. The fact that there must inevitably be a closing inventory at the end of each period and therefore an opening inventory at the beginning of each period makes it necessary to allow for the amount of change in the inventory. Thus, if the opening inventory for a given period is $8,000.00, it is evident that to the purchases for the period there must be added $2,000.00, the amount of decrease in the inventory, in order to obtain the important figure known as cost of goods sold.

Similar considerations apply to inventories in manufacturing accounting. It is necessary to consider three kinds of inventories: (1) raw materials, (2) goods in process, (3) finished goods.

*1. Raw Materials Inventory*. The fluctuation which takes place in the raw materials inventory is significant because to the purchases

for a given period must be added the decrease, or from the purchases for a given period must be subtracted the increase, to determine the cost of raw materials consumed in the manufacturing process. To illustrate, assume that during a given month purchases of raw materials amount to $12,000.00, that the opening inventory for the month was $10,000.00 and that the closing inventory was $11,000.00. This means that the cost of goods consumed is $12,000.00 less the increase in the inventory, $1,000.00, or $11,000.00.

*2. Goods in Process.* Goods in process represent materials which have been put into manufacturing but which are not yet completed. They are usually found in all stages of completion ranging from those which have just entered the manufacturing process to those which are nearly ready to be transferred to finished goods. The difficulties which lie in the way of a correct valuation of goods in process are many, unless there is in operation a cost system which makes it possible to accumulate all elements of cost, as materials proceed through the factory. Naturally, such costs are comprised of raw materials plus direct labor expended to date, plus a proper amount of overhead. In preparing the financial statements at the end of the accounting period, it is necessary to take into account the amount of the opening and closing inventories of the goods in process in order to determine the cost of goods manufactured.

*3. Finished Goods.* Finished goods are the products of the factory which have passed through all required processes of manufacture. In order to determine the cost of goods sold, it is necessary to take into account the amount of finished goods at the beginning and at the end of the accounting period. Thus, if it is found that cost of goods manufactured in a given month amounts to $150,000.00 and it is shown that the opening and closing finished goods inventories amount to $45,000.00 and $40,000.00 respectively, it is evident that cost of goods sold is $155,000.00, that is, cost of goods produced plus decrease of $5,000.00 in finished goods inventory.

**Accounting Procedure Illustrated.** In order to illustrate the principles involved in manufacturing accounting and to show the variations from procedure already explained for merchandising accounting, an example is given. In Fig. 147 is shown the trial balance of the A, B, C Company as at December 31, 19—.

## A, B, C Company

### Trial Balance

**as at December 31, 19–7**

| | | |
|---|---|---|
| *Accounts Payable* | | *100,000.00* |
| *Accounts Receivable* | *120,000.00* | |
| *Advertising* | *2,500.00* | |
| *Bad Debts* | *1,000.00* | |
| *Buildings* | *150,000.00* | |
| *Cash on Deposit* | *20,000.00* | |
| *Commissions Paid Salesmen* | *10,000.00* | |
| *Common Stock* | | *250,000.00* |
| *Depreciation—Buildings* | *6,000.00* | |
| *Depreciation—Machinery* | *5,000.00* | |
| *Discount on Sales* | *12,000.00* | |
| *Discount on Purchases* | | *6,000.00* |
| *Factory Expense* | *300,000.00* | |
| *Finished Goods Inventory, Dec. 31, 19–6* | *40,000.00* | |
| *Freight and Cartage Inward* | *2,000.00* | |
| *Freight and Cartage Outward* | *3,000.00* | |
| *Fuel Inventory* | *2,500.00* | |
| *Goodwill* | *50,000.00* | |
| *Insurance on Building and Machinery* | *1,000.00* | |
| *Insurance on Finished Goods* | *2,000.00* | |
| *Insurance Unexpired on Building and Machinery* | *500.00* | |
| *Insurance Unexpired on Finished Goods* | *200.00* | |
| *Interest Accrued on Investments* | *800.00* | |
| *Interest Accrued on Mortgage Payable* | | *750.00* |
| *Interest Expense* | *3,000.00* | |
| *Interest Income* | | *2,000.00* |
| *Investments* | *50,000.00* | |
| *Labor, Factory Payroll* | *75,000.00* | |
| *Land* | *10,000.00* | |
| *Machinery* | *50,000.00* | |
| *Mortgage on Plant* | | *50,000.00* |
| *Notes Payable* | | *25,000.00* |
| *Notes Receivable* | *20,000.00* | |
| *Office Expenses* | *5,000.00* | |
| *Office Furniture and Fixtures* | *8,000.00* | |
| *Office Payroll* | *25,000.00* | |
| *Organization Expenses* | *9,000.00* | |
| *Payroll, Factory, Accrued* | | *2,000.00* |
| *Payroll, Office, Accrued* | | *1,000.00* |
| *Petty Cash* | *500.00* | |
| *Prepaid Expenses* | *2,000.00* | |
| *Profit and Loss, 19–6, Deficit* | *15,450.00* | |
| *Raw Material Inventory, Dec. 31, 19–6* | *30,000.00* | |
| *Raw Material Purchases* | *300,000.00* | |
| *Repairs to Building* | *1,600.00* | |
| *Repairs to Machinery* | *1,200.00* | |

Fig. 147—*Continued on page 310*

**A, B, C Company**

TRIAL BALANCE—*Continued*

**as at December 31, 19—**

| | | |
|---|---|---|
| *Reserve for Bad Debts* | | 2,000.00 |
| *Reserve for Depreciation—Buildings* | | 20,000.00 |
| *Reserve for Depreciation—Machinery* | | 10,000.00 |
| *Returns and Allowances of Sales* | 4,000.00 | |
| *Salaries, General Officers* | 45,000.00 | |
| *Salaries, Salesmen* | 30,000.00 | |
| *Sales* | | 1,000,000.00 |
| *Salesmen's Accounts—Advertising on Sales* | 3,000.00 | |
| *Subscriptions and Donations* | 1,000.00 | |
| *Taxes, U. S. Income* | 10,000.00 | |
| *Taxes, Real Estate* | 6,500.00 | |
| *Work in Process Inventory, Dec. 31, 19-6* | 35,000.00 | |
| | 1,468,750.00 | 1,468,750.00 |

Fig. 147

Of the organization expenses one-third, or $3,000.00, is to be amortized or written off in the current year. The inventories as at December 31, 19-7, are as follows:

| | |
|---|---|
| *Raw Materials* | 28,000.00 |
| *Work in Process* | 32,000.00 |
| *Finished Goods* | 42,000.00 |

It is necessary to make four adjusting entries, one to write off $3,000.00 of organization expenses and the three remaining ones to bring the closing inventories for raw materials, work in process, and finished goods upon the books. These adjusting entries, together with the adjusted trial balance, are shown in the work sheet in Fig. 148. Furthermore, the items in the adjusted trial balance are carried to the Cost of Goods Sold columns and the Profit and Loss columns and the Balance Sheet columns according to their character.

Following the work sheet, which is called Exhibit I and is shown in Fig. 148, are shown the following statements:

Exhibit II—Balance Sheet
Exhibit III—Profit and Loss Statement
    Schedule 1—Cost of Goods Sold
    Schedule 2—Selling Expenses
    Schedule 3—Administrative Expenses
    Schedule 4—Financial Expenses
    Schedule 5—Financial Income

**A, B, C Company**

EXHIBIT I—WORKING PAPERS

**December 31, 19–7**

| | Trial Balance Dr. | Trial Balance Cr. | Adjustments Dr. | Adjustments Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. | Cost of Goods Sold Dr. | Cost of Goods Sold Cr. | Profit and Loss Expenses | Profit and Loss Income | Balance Sheet Assets | Balance Sheet Liabilities |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Accounts Payable* | | 100,000 00 | | | | 100,000 00 | | | | | | 100,000 00 |
| *Accounts Receivable* | 120,000 00 | | | | 120,000 00 | | | | | | 120,000 00 | |
| *Advertising* | 2,500 00 | | | | 2,500 00 | | | | 2,500 00 | | | |
| *Bad Debts* | 1,000 00 | | | | 1,000 00 | | | | 1,000 00 | | | |
| *Buildings* | 150,000 00 | | | | 150,000 00 | | | | | | 150,000 00 | |
| *Cash on Deposit* | 20,000 00 | | | | 20,000 00 | | | | | | 20,000 00 | |
| *Commissions Paid Salesmen* | 10,000 00 | | | | 10,000 00 | | | | 10,000 00 | | | |
| *Common Stock* | | 250,000 00 | | | | 250,000 00 | | | | | | 250,000 00 |
| *Depreciation—Buildings* | 6,000 00 | | | | 6,000 00 | | 6,000 00 | | | | | |
| *Depreciation—Machinery* | 5,000 00 | | | | 5,000 00 | | 5,000 00 | | | | | |
| *Discount on Sales* | 12,000 00 | | | | 12,000 00 | | | | 12,000 00 | | | |
| *Discount on Purchases* | | 6,000 00 | | | | 6,000 00 | | | | 6,000 00 | | |
| *Factory Expense* | 300,000 00 | | | | 300,000 00 | | 300,000 00 | | | | | |
| *Finished Goods Inventory, Dec. 31, 19–6* | 40,000 00 | | | [4] 42,000 00 | 40,000 00 | 42,000 00 | 40,000 00 | 42,000 00 | | | | |
| *Freight and Cartage Inward* | 2,000 00 | | | | 2,000 00 | | 2,000 00 | | | | | |
| *Freight and Cartage Outward* | 3,000 00 | | | | 3,000 00 | | | | 3,000 00 | | | |
| *Fuel Inventory* | 2,500 00 | | | | 2,500 00 | | | | | | 2,500 00 | |
| *Goodwill* | 50,000 00 | | | | 50,000 00 | | | | | | 50,000 00 | |
| *Insurance on Building and Machinery* | 1,000 00 | | | | 1,000 00 | | 1,000 00 | | | | | |
| *Insurance on Finished Goods* | 2,000 00 | | | | 2,000 00 | | 2,000 00 | | | | | |
| *Insurance Unexpired on Building and Machinery* | 500 00 | | | | 500 00 | | | | | | 500 00 | |
| *Insurance Unexpired on Finished Goods* | 200 00 | | | | 200 00 | | | | | | 200 00 | |

*Continued on following page*

## A, B, C Company
### Exhibit I—Working Papers—*Continued*
**December 31, 19—**

| | Trial Balance | | Adjustments | | Adjusted Trial Balance | | Cost of Goods Sold | | Profit and Loss | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Dr. | Cr. | Dr. | Cr. | Dr. | Cr. | Dr. | Cr. | Expenses | Income | Assets | Liabilities |
| *Interest Accrued on Investments* | 800 00 | | | | 800 00 | | | | | | 800 00 | |
| *Interest Accrued on Mortgage Payable* | | 750 00 | | | | 750 00 | | | | | | 750 00 |
| *Interest Expense* | 3,000 00 | | | | 3,000 00 | | | | 3,000 00 | | | |
| *Interest Income* | | 2,000 00 | | | | 2,000 00 | | | | 2,000 00 | | |
| *Investments* | 50,000 00 | | | | 50,000 00 | | | | | | 50,000 00 | |
| *Labor, Factory Payroll* | 75,000 00 | | | | 75,000 00 | | 75,000 00 | | | | | |
| *Land* | 10,000 00 | | | | 10,000 00 | | | | | | 10,000 00 | |
| *Machinery* | 50,000 00 | | | | 50,000 00 | | | | | | 50,000 00 | |
| *Mortgage on Plant* | | 50,000 00 | | | | 50,000 00 | | | | | | 50,000 00 |
| *Notes Payable* | | 25,000 00 | | | | 25,000 00 | | | | | | 25,000 00 |
| *Notes Receivable* | 20,000 00 | | | | 20,000 00 | | | | | | 20,000 00 | |
| *Office Expenses* | 5,000 00 | | | | 5,000 00 | | | | 5,000 00 | | | |
| *Office Furniture and Fixtures* | 8,000 00 | | | | 8,000 00 | | | | | | 8,000 00 | |
| *Office Payroll* | 25,000 00 | | | | 25,000 00 | | | | 25,000 00 | | | |
| *Organization Expenses* | 9,000 00 | | | [1] 3,000 00 | 6,000 00 | | | | | | 6,000 00 | |
| *Payroll, Factory, Accrued* | | 2,000 00 | | | | 2,000 00 | | | | | | 2,000 00 |
| *Payroll, Office, Accrued* | | 1,000 00 | | | | 1,000 00 | | | | | | 1,000 00 |
| *Petty Cash* | 500 00 | | | | 500 00 | | | | | | 500 00 | |
| *Forwarded* | 984,000 00 | 436,750 00 | | | | | | | | | | |
| *Prepaid Expenses* | 2,000 00 | | | | 2,000 00 | | | | | | 2,000 00 | |
| *Profit and Loss, 19–6, Deficit* | 15,450 00 | | | | 15, 150 00 | | | | | | 15,450 00 | |

*Continued on opposite page.*

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Raw Material Inventory, Dec. 31, 19-6* | 30,000 00 | | | [2] 28,000 00 | 30,000 00 | 28,000 00 | 30,000 00 | 28,000 00 | | | | |
| *Raw Material Purchases* | 300,000 00 | | | | 300,000 00 | | 300,000 00 | | | | | |
| *Repairs to Building* | 1,600 00 | | | | 1,600 00 | | 1,600 00 | | | | | |
| *Repairs to Machinery* | 1,200 00 | | | | 1,200 00 | | 1,200 00 | | | | | |
| *Reserve for Bad Debts* | | 2,000 00 | | | | 2,000 00 | | | | | | 2,000 00 |
| *Reserve for Depreciation—Buildings* | | 20,000 00 | | | | 20,000 00 | | | | | | 20,000 00 |
| *Reserve for Depreciation—Machinery* | | 10,000 00 | | | | 10,000 00 | | | | | | 10,000 00 |
| *Returns and Allowances of Sales* | 4,000 00 | | | | 4,000 00 | | | | 4,000 00 | | | |
| *Salaries, General Officers* | 45,000 00 | | | | 45,000 00 | | | | 45,000 00 | | | |
| *Salaries, Salesmen* | 30,000 00 | | | | 30,000 00 | | | | 30,000 00 | | | |
| *Sales* | | 1,000,000 00 | | | | 1,000,000 00 | | | | 1,000,000 00 | | |
| *Salesmen's Accounts—Advertising on Sales* | 3,000 00 | | | | 3,000 00 | | | | | | 3,000 00 | |
| *Subscriptions and Donations* | 1,000 00 | | | | 1,000 00 | | | | 1,000 00 | | | |
| *Taxes, U.S. Income* | 10,000 00 | | | | 10,000 00 | | | | | | *10,000 00 | |
| *Taxes, Real Estate* | 6,500 00 | | | | 6,500 00 | | 6,500 00 | | | | | |
| *Work in Process* | 35,000 00 | | | [3] 32,000 00 | 35,000 00 | 32,000 00 | 35,000 00 | 32,000 00 | | | | |
| | 484,750 00 | 1,032,000 00 | | | | | | | | | | |
| *Balance Brought Forward* | 984,000 00 | 436,750 00 | | | | | | | | | | |
| | 1,468,750 00 | 1,468,750 00 | | | | | | | | | | |
| *Raw Material Inventory, Dec. 31, 19-7* | | | [2] 28,000 00 | | 28,000 00 | | | | | | 28,000 00 | |
| *Work in Process Inventory, Dec. 31, 19-7* | | | [3] 32,000 00 | | 32,000 00 | | | | | | 32,000 00 | |
| *Organization Expenses Amortized* | | | [1] 3,000 00 | | 3,000 00 | | | | 3,000 00 | | | |
| *Finished Goods Inventory, Dec. 31, 19-7* | | | [4] 42,000 00 | | 42,000 00 | | | | | | 42,000 00 | |
| *Cost of Goods Sold* | | | | | | | | 703,300 00 | 703,300 00 | | | |
| *Profit for Period* | | | | | | | | | 160,200 00 | | | 160,200 00 |
| | | | 105,000 00 | 105,000 00 | 1,570,750 00 | 1,570,750 00 | 805,300 00 | 805,300 00 | 1,008,000 00 | 1,008,000 00 | 620,950 00 | 620,950 00 |

## A, B, C Company

### Exhibit II—Balance Sheet

**December 31, 19–7**

| | | | | |
|---|---|---|---|---|
| ASSETS: | | | | |
| *Current Assets:* | | | | |
| Cash on Deposit | | $ 20,000.00 | | |
| Petty Cash | | 500.00 | $ 20,500.00 | |
| Notes and Accounts Receivable | | | | |
| Customers: | | | | |
| Accounts Receivable | $120,000.00 | | | |
| Notes Receivable | 20,000.00 | 140,000.00 | | |
| Less: | | | | |
| Reserve for Bad Debts | | 2,000.00 | 138,000.00 | |
| Inventories: | | | | |
| Finished Goods | | $ 42,000.00 | | |
| Raw Material | | 28,000.00 | | |
| Work in Process | | 32,000.00 | 102,000.00 | |
| Other Current Assets: | | | | |
| Interest Accrued on Investments | | $ 800.00 | 800.00 | |
| Total Current Assets | | | | $261,300.00 |
| *Investments:* | | | | |
| Investments | | | $ 50,000.00 | 50,000.00 |
| *Property, Plant and Equipment:* | | | | |
| Buildings | | $150,000.00 | | |
| Land | | 10,000.00 | | |
| Machinery | | 50,000.00 | | |
| Office Furniture and Fixtures | | 8,000.00 | $218,000.00 | |
| Less: | | | | |
| Reserve for Depreciation of Buildings | | $ 20,000.00 | | |
| Reserve for Depreciation of Machinery | | 10,000.00 | 30,000.00 | 188,000.00 |
| *Intangible Assets:* | | | | |
| Goodwill | | | $ 50,000.00 | 50,000.00 |
| *Deferred Charges:* | | | | |
| Insurance Unexpired—Buildings and Machinery | | | $ 500.00 | |
| Insurance Unexpired—Finished Goods | | | 200.00 | |
| Prepaid Expenses | | | 2,000.00 | |
| Fuel Inventory | | | 2,500.00 | |
| Organization Expense | | | 6,000.00 | |
| Salesmen's Accounts—Advance on Salaries | | | 3,000.00 | 14,200.00 |
| TOTAL ASSETS | | | | $563,500.00 |

Fig. 148—*Continued on opposite page*

## A, B, C Company

### Exhibit II—Balance Sheet—*Continued*

**December 31, 19–7**

| | | | |
|---|---|---|---|
| LIABILITIES: | | | |
| *Current Liabilities:* | | | |
| Accounts Payable | | $100,000.00 | |
| Notes Payable | | 25,000.00 | |
| Interest Accrued on Mortgage Payable | | 750.00 | |
| Accrued Expenses | | | |
| Factory Payroll | $ 2,000.00 | | |
| Office Payroll | 1,000.00 | 3,000.00 | |
| Total Current Liabilities | | | $128,750.00 |
| *Funded Debt:* | | | |
| Mortgage on Plant | | $ 50,000.00 | 50,000.00 |
| *Capital Stock:* | | | |
| Common Stock | | $250,000.00 | 250,000.00 |
| *Surplus:* | | | |
| Profit for Period 19–7 | | $160,200.00 | |
| Less: | | | |
| Deficit, 19–6 | $15,450.00 | | |
| Taxes, U.S. Income | 10,000.00 | 25,450.00 | |
| Earned Surplus | | | 134,750.00 |
| TOTAL LIABILITIES | | | $563,500.00 |

Fig. 148

## A, B, C Company

### Exhibit III—Profit and Loss Statement

**Year Ended December 31, 19–7**

| | | |
|---|---|---|
| *Gross Sales* | *1,000,000.00* | |
| *Less Sales Returns and Allowances* | *4,000.00* | |
| *Net Sales* | | *996,000.00* |
| *Cost of Goods Sold (Schedule 1)* | | *703,300.00* |
| *Gross Profit* | | *292,700.00* |
| *Operating Expenses:* | | |
| *Selling Expense (Schedule 2)* | *45,500.00* | |
| *Administrative Expense (Schedule 3)* | *77,000.00* | |
| *Organization Expense Amortized* | *3,000.00* | |
| *Total Operating Expense* | | *125,500.00* |
| *Net Profit on Operations* | | *167,200.00* |
| *Financial Expense (Schedule 4)* | | *15,000.00* |
| | | *152,200.00* |
| *Financial Income (Schedule 5)* | | *8,000.00* |
| *Net Profit for Year Ending Dec. 31, 19–7* | | *160,200.00* |
| *Less:* | | |
| *U.S. Taxes—Income* | | *10,000.00* |
| | | *150,200.00* |

Fig. 148—*Continued on following page*

**A, B, C Company**

SCHEDULE 1—COST OF GOODS SOLD

**December 31, 19-7**

| | | | |
|---|---|---|---|
| *Inventory, Raw Material, Dec. 31, 19—* | | 30,000.00 | |
| *Net Purchases* | | 300,000.00 | |
| | | 330,000.00 | |
| *Inventory, Raw Material, Dec. 31, 19—* | | 28,000.00 | |
| *Cost of Raw Materials Used* | | | 302,000.00 |
| *Direct Labor* | | | 75,000.00 |
| *Prime Cost* | | | 377,000.00 |
| *Manufacturing Overhead:* | | | |
| *Depreciation:* | | | |
| *Buildings* | 6,000.00 | | |
| *Machinery* | 5,000.00 | 11,000.00 | |
| *Factory Expense* | | 300,000.00 | |
| *Freight and Cartage In* | | 2,000.00 | |
| *Insurance:* | | | |
| *Buildings and Machinery* | 1,000.00 | | |
| *Finished Goods* | 2,000.00 | 3,000.00 | |
| *Repairs:* | | | |
| *Buildings* | 1,600.00 | | |
| *Machinery* | 1,200.00 | 2,800.00 | |
| *Taxes, Real Estate* | | 6,500.00 | |
| *Total Manufacturing Expense* | | | 325,300.00 |
| *Cost to Manufacture* | | | 702,300.00 |
| *Inventory, Work in Process, Dec. 31, 19-7* | | | 35,000.00 |
| *Total* | | | 737,300.00 |
| *Inventory, Work in Process, Dec. 31, 19-7* | | | 32,000.00 |
| *Cost of Goods Manufactured* | | | 705,300.00 |
| *Inventory, Finished Goods, Dec. 31, 19-7* | | | 40,000.00 |
| *Total* | | | 745,300.00 |
| *Inventory, Finished Goods, Dec. 31, 19-7* | | | 42,000.00 |
| *Cost of Goods Sold* | | | 703,300.00 |

Fig. 148—*Continued on opposite page*

## A, B, C Company

### SCHEDULES 2 TO 5—SUPPORTING SCHEDULES

**December 31, 19-7**

**Schedule 2—Selling Expenses**

| | | |
|---|---|---|
| *Advertising* | 2,500.00 | |
| *Commissions Paid Salesmen* | 10,000.00 | |
| *Freight and Cartage Outward* | 3,000.00 | |
| *Salesmen's Salaries* | 30,000.00 | |
| *Total Selling Expenses* | | 45,500.00 |

**Schedule 3—Administrative Expenses**

| | | |
|---|---|---|
| *Salaries, General Officers* | 45,000.00 | |
| *Subscriptions and Donations* | 1,000.00 | |
| *Bad Debts* | 1,000.00 | |
| *Office Expenses* | 5,000.00 | |
| *Office Payroll* | 25,000.00 | |
| *Total Administrative Expenses* | | 77,000.00 |

**Schedule 4—Financial Expenses**

| | | |
|---|---|---|
| *Discount on Sales* | 12,000.00 | |
| *Interest Expense* | 3,000.00 | |
| *Total Financial Expenses* | | 15,000.00 |

**Schedule 5—Financial Income**

| | | |
|---|---|---|
| *Purchase Discount* | 6,000.00 | |
| *Interest Income* | 2,000.00 | |
| *Total Financial Income* | | 8,000.00 |

Fig. 148—*Concluded*

# *Chapter* 19

# ANALYZING STATEMENTS

**Purpose of Statements.** In preceding chapters much attention has been given to financial statements, particularly the balance sheet and the statement of profit and loss, or income statement. These are the fundamental statements and are looked upon by investors, analysts, credit men, bankers, and others as essential to an understanding of the condition and progress of an enterprise. The balance sheet is the statement which shows the condition of a business at a given time. The profit and loss statement, or income statement, is the one which shows what changes have taken place in the condition of an enterprise during the accounting period, that is, the month or the year. The balance sheet and the statement of profit and loss, if properly constructed, in themselves and without further analysis, indicate many important relationships. For example, a properly constructed balance sheet shows one at a glance the status of the working capital, because it gives the total of the current assets, and on the opposite side of the balance sheet it gives the total of the current liabilities. The amount of the working capital is found by deducting the total of the current liabilities from the total of the current assets. The working capital ratio also may be ascertained easily by dividing the total of the current assets by the total of the current liabilities. Thus, assuming that in a given instance, current assets amount to $500,000.00 and the current liabilities to $100,000.00, the working capital is $400,000.00 (found by subtracting $100,000.00 from $500,000.00) and the working capital ratio is 5 to 1, since the total of the current assets is five times the total of the current liabilities.

The balance sheet and the profit and loss statement serve many purposes, among the most important of which are the following: (1) requirements of investors, (2) requirements of government, (3) requirements of creditors, (4) requirements of managers.

In some respects the requirements of the four groups indicated above are identical, but it will be found that as a rule each group makes a special demand for information in which it is particularly interested. Sometimes, of course, each group may find in the same statement the information which it requires, notwithstanding the fact that its requirements are different from the requirements of the other groups. Frequently, however, it is necessary to so construct and arrange financial statements as to meet the peculiar demands of a certain group. With these considerations in mind the requirements of these four important groups may be briefly considered.

*1. Requirements of Investors.* The way in which capitalistic society is organized today, much wealth is owned by people who do not use it. In other words, an extensive absentee ownership of property exists. Since thousands of investors thus transfer to others the management of their property, they demand enough information from those who use their property to enable them to reach a satisfactory conclusion relative to the present and future disposition which they may wish to make of their funds. To a considerable extent, investors rely upon agencies which perform for them the work of investigation and analysis, but whether they do this work themselves or delegate it to experts, the same requirements must be met. There must be provided sufficient data upon which to base analysis and render judgments.

Investors are creditors, but they should be distinguished from the creditors (considered in No. 3 following) in that they represent a group which extends long-term credit to business concerns, whereas *creditors* (as referred to in No. 3 following) extend credit for relatively short terms.

*2. Requirements of Government.* The demands of governmental agencies for information are becoming increasingly extensive, so much so, in fact, that the work of preparing required reports is in some cases burdensome and expensive. Much of the information which must be reported to these governmental agencies is of an accounting character and some of the information which is of a statistical character must be secured from accounting records. Taxation alone demands the preparation of detailed reports which can be prepared only when properly constructed financial state-

ments are available. To illustrate, the income tax may be considered. Not only must corporations and partnerships report information of an accounting character, but individuals as well are compelled to prepare returns which involve a considerable amount of accounting information.

Another illustration of the need of adequate accounting records, in order to fulfill governmental requirements, is found in connection with the reports which must be made to the Securities and Exchange Commission. The supervision which this Commission exercises over the sale of new securities is extensive and its work is based to a large extent on accounting principles and their applications.

As a further illustration, the work of the Federal Trade Commission may be considered. Its investigations involve the consideration of accounting information and its reports and decisions reflect the importance of accounting as a means of governmental supervision and control of industry and trade.

Naturally, the requirements of governmental agencies for information involve extensive application of the principles of analysis of statements. It is only by applying the principles of analysis to statements which are submitted by business enterprises that the government is able to provide equitable treatment to the various parties concerned.

*3. Requirements of Creditors.* Here short-term creditors are referred to as distinguished from investors already mentioned above. The United States is typically a credit using nation. Retailers sell on credit and buy on credit and it may be said truthfully that the credit structure involves practically all commercial and governmental undertakings. There are long-established agencies which make it their business to broadcast facts relative to the credit standing of all kinds of private enterprises. Manufacturers and middlemen extend credit to retailers only when satisfactory information relative to their debt capacities is forthcoming. The same is true of commercial banks, which in some instances require highly detailed information of an accounting character upon which to base extensions of credit.

*4. Requirements of Managers.* Management has become a science, and managerial policies must be based upon all available informa-

tion of a pertinent character. Sometimes corporations prepare balance sheets and profit and loss statements to be used for internal or managerial purposes only, whereas they publish less detailed statements for public consumption. Management must go beyond the surface study of financial statements and must demand such analysis of costs and expenses as may be necessary for the efficient operation and control of an enterprise.

To illustrate, suppose that the manager of an enterprise is interested in knowing what may be the relation of a depreciation charge of $10,000.00 yearly to the working capital status of his concern. In order to secure an understanding of the relation of depreciation to working capital, it is necessary for him to determine what the significance of the annual provision for depreciation is. An analysis will show him that if the depreciation charge is actually earned it is probable that it will take the form of an increase in working capital, since earnings usually pass through the stage of cash. Of course, this may not mean a permanent increase in working capital, but it is a consideration of real value to the manager in his formation of policies relative to the provision of a satisfactory working capital position.

**Balance Sheet Construction.** The construction of the balance sheet is partly a matter of title and form, partly a matter of classification, and partly a matter of accounting principles. Many titles have been proposed, among which some of the most common are the following: (1) balance sheet, (2) financial statement, (3) statement of assets and liabilities, (4) statement of assets, liabilities, and capital.

The simple title, *balance sheet*, is the one most frequently used and is also the one most suitable for ordinary purposes. Another title, *statement of affairs*, is used in referring to the balance sheet of an insolvent enterprise. It differs radically from the balance sheet of a going concern, since it is arranged to show what values may be realized to meet the various claims against the concern.

After deciding upon the correct title for a balance sheet, it is necessary to decide what form of balance sheet to employ. Fundamentally, balance sheets group themselves into two basic forms, namely, the account form and the report form. In the account form

the assets are placed on the left-hand side and the liabilities and capital on the right-hand side.

In the report form, the assets are placed above and the liabilities and capital below. Both forms are popular, but corporations prefer the account form in published reports. English accountants reverse the arrangement of the account form of the balance sheet, placing liabilities and capital on the left-hand side and assets on the right-hand side. One authority suggests that the reason for this is that the conservative Englishman likes to see his debts first, whereas the hopeful American prefers to look at his assets first.

**Assets.** A satisfactory balance sheet requires much more than the mere listing of the assets of a concern. The assets must be classified not only properly and so listed as to show totals of important groups, but they also must be evaluated according to recognized principles of accounting. Undoubtedly, an understanding of the principles followed in determining the stated values of assets is of fundamental importance to the understanding of the balance sheet. In this connection it may be stated that the balance sheet of a going concern should reflect going concern values, not values which exist when an enterprise is insolvent. Most values, as reflected in the balance sheets of going concerns, exist simply because the enterprise has excellent prospects of continuing indefinitely in business. Naturally, assets are brought upon the books at whatever they cost and it is a matter of common sense to retain this cost figure, except under unusual conditions. What a fixed asset costs may not be an index of its real value, but, as a rule, there is much value in this cost figure. Complete departure from the cost figure may launch the accountant upon a sea of speculation which will lead him into far greater error than will the attempt to account for the value of an asset primarily with reference to its cost. It is not necessary to depart from the cost basis of valuation in order to make due allowance for depreciation, obsolescence, depletion, and other factors.

The following subdivision of assets is illustrative of good practice: (1) current, (2) fixed, (3) investments, (4) deferred charges, (5) intangibles. This grouping of assets in itself affords a basis for analysis because it classifies all assets according to their significance in the business. A brief discussion of each group follows:

*1. Current Assets.* The primary characteristic of current assets is that they are not to be used up in the business, but they are to be transferred shortly into some other form of current assets. Thus cash is converted into merchandise through purchases. Merchandise in turn is converted into accounts receivable, which are in turn converted into cash. Because of this circulating character of current assets, they sometimes are called circulating assets. Below is given a list of the more important kinds of current assets: (1) cash, (2) accounts receivable, (3) notes receivable, (4) merchandise, (5) temporary investments.

*2. Fixed Assets.* Fixed assets, unlike current assets, are used up or worn out in performing services. They are sold only to secure whatever scrap value they may have at the end of their useful life. Illustrations of fixed assets are given below: (1) land, (2) buildings, (3) machinery, (4) delivery equipment, (5) furniture and fixtures.

*3. Investments.* Under the head of investments should be listed all sums invested in outside enterprises, except those of a strictly temporary nature, which may be listed as current assets. Sometimes investments are made for purposes of controlling competitive or supplementary enterprises. Sometimes they are made simply to give employment to capital not presently required in the business. Sometimes items in this group are shifted to the fixed asset division when they are no longer regarded as investments; thus land held for future development would be an investment, but when put into use would become a fixed asset. Below are listed some typical investments: (1) land (not in use), (2) bonds, (3) stocks of another company.

*4. Deferred Charges.* Under this head are included prepaid expenses, such as prepaid insurance and prepaid advertising. A prepaid expense is one which is paid before the benefit from it is derived and it may therefore be treated as an asset. Among important items of prepaid expenses are: (1) prepaid insurance, (2) prepaid advertising, (3) prepaid rent, (4) prepaid interest.

*5. Intangible Assets.* Intangible assets are those which have no physical texture. Sometimes intangible assets play an important part in the success and welfare of an enterprise, as, for example, where important patents are owned upon which the enterprise

depends for a monopoly of certain kinds of its output. Again goodwill sometimes is a very important factor in business. The important types of intangible assets may be classified as follows: (1) goodwill, (2) patents, (3) franchises, (4) trade-marks, (5) copyrights.

**Liabilities and Net Worth.** Liabilities and net worth are expressed on the so-called *liabilities* side of the balance sheet. These represent the equities in the business, the equities of the creditors taking the form of debts with more or less specific maturities, whereas the equities of the proprietors (net worth) have no maturity date and are not looked upon as legal debts. These equities are related in various ways to the assets shown on the opposite side of the balance sheet. The assets must provide the necessary funds for the payment of debts as they fall due and also for the payment of dividends to proprietors. Only by properly classifying assets and equities can the interrelationship which exists between assets and equities be made evident. Liabilities are usually classified as follows: (1) current, (2) fixed, (3) contingencies.

Net worth classification depends upon the character of the enterprise—whether it be sole-proprietorship, partnership, or a corporation. For present purposes the corporate form of organization is assumed and net worth is therefore classified as follows: (1) common stock, (2) preferred stock, (3) surplus.

The foregoing classification of liabilities will now be considered.

*1. Current Liabilities.* Current liabilities are usually stated as being those which must be paid within one year. This is a rule-of-thumb but serves quite well for most purposes. It is evident that the amount and condition of the current assets are the primary considerations in determining whether current liabilities can be met satisfactorily. It is from this relationship that there arises the important concept of the *working capital ratio*, which is found by dividing the amount of the current assets by the amount of the current liabilities. Among the usual current assets found on commercial balance sheets are the following: (1) accounts payable, (2) notes payable, (3) acceptances payable, (4) accrued wages, (5) accrued taxes, (6) accrued interest.

*2. Fixed Liabilities.* Fixed liabilities are those which mature and must be paid or refunded more than one year hence. Fixed liabilities

are usually of large amount. In the case of corporations, they usually take the form of bond issues, whereas, in the case of sole proprietorships and partnerships, they usually take the form of mortgages payable. As a rule, it is desirable to make special provision for the liquidation of debts of this type by establishing what are commonly known as sinking funds. These sinking funds are created in accordance with the provisions of the mortgage or trust deed by making periodic payments into the sinking fund, which is placed under the control of a trustee who manages the fund for the benefit of the bondholders. There are many technical considerations relating to the creation of sinking funds which need not be considered here.

The following considerations apply to net worth. Capital stock may be of one or more kinds, and frequently both common stock and preferred stock are found in the balance sheet; if there is only one kind of capital stock it is, of course, all common, although it may be designated by the account title "Capital Stock." Preferred stock is so called because it is given a preference over the common stock, usually as to dividends, but sometimes also as to assets; that is, in case of liquidation the preferred stock is redeemed before the common stock is redeemed. Since capital stock must be retained on the books at the price at which it is sold, accumulated profits of a corporation must be shown in a separate account termed the Surplus account. Deficiencies or net losses must likewise be charged against the Surplus account, so that at any time it may be said that the Surplus account represents the excess of assets over liabilities plus capital stock.

**Construction of the Income Statement.** Various titles have been applied to the income statement, among which are the following: (1) statement of profit and loss, (2) profit and loss statement, (3) statement of operations, (4) operating statement, (5) statement of income and expense.

The purpose of the income statement is to serve as a supplement to the balance sheet by showing how changes in net worth have occurred. Thus, if the balance sheet as at December 31, 19–7, shows a net worth of $50,900.00 and a balance sheet for the same enterprise as at December 31, 19–8, shows a net worth of $60,000.00, an understanding of the reasons for the increase of $9,100.00 can be

secured only by consulting the income statement for the year ending December 31, 19–8. Under incomplete systems of accounting, such as single entry, the income statement may be lacking, but under a double entry system, which employs a correct classification of nominal as well as real accounts, the information for the construction of the income statement is available. This will be made clear to the student if he will examine the work sheet shown in the preceding chapter. All information for the construction not only of the balance sheet but also for the profit and loss statement, together with supporting schedules, is found in this work sheet.

It may be said that the income statement, or statement of profit and loss, is a classified summary of all revenues and expenses. Naturally, revenues should be placed first because they must be sufficient to cover all expenses and leave a margin of net profit if a concern is successful. The student will do well to review the form of the statement of profit and loss shown in Fig. 148 together with the supporting schedules.

**Interpretation of the Balance Sheet.** Various methods of interpreting balance sheets are employed. These will be considered under the following heads: (1) comparative balance sheet, (2) statement of funds derived and applied, (3) ratios.

For present purposes balance sheets of the Atlas Corporation, dated December 31, 19–6, and December 31, 19–7, respectively, will be used. These balance sheets are reduced to fairly simple classifications in order to avoid confusing the study of principles by presenting too much detail. They are shown respectively in Figs. 149 and 150.

There is in existence an abundance of raw material for the student who wishes to apply in practice the procedures herein explained. Perhaps the best sources of such material are to be found in the published reports of corporations. It is suggested that these be secured for ten concerns covering a period of five years, the last report in each of the ten series being for the most recent year for which such published reports are available. Such a collection will be found useful for future reference and will supply data helpful in studying the application of principles explained in *Modern Practical Accounting—Advanced.*

**Atlas Corporation**

BALANCE SHEET

**as at December 31, 19–6**

| | | | | | |
|---|---|---|---|---|---|
| *Current Assets:* | | | *Current Liabilities:* | | |
| Cash | $ 6,000.00 | | Accounts Payable | $12,000.00 | |
| Accounts Receivable | 25,000.00 | | Notes Payable | 3,000.00 | $15,000.00 |
| Inventory | 20,000.00 | $51,000.00 | | | |
| *Fixed Assets:* | | | *Fixed Liabilities:* | | |
| Land | $ 8,000.00 | | Bonds | | 20,000.00 |
| Buildings | 12,000.00 | | *Net Worth:* | | |
| Delivery Equipment | 2,000.00 | | Capital Stock | | 20,000.00 |
| Furniture and Fixtures | 1,500.00 | 23,500.00 | Surplus | | 26,000.00 |
| *Investments:* | | | | | |
| Bonds | | 6,000.00 | | | |
| *Deferred Charges:* | | | | | |
| Prepaid Insurance | | 500.00 | | | |
| | | $81,000.00 | | | $81,000.00 |

Fig. 149

**Atlas Corporation**

BALANCE SHEET

**as at December 31, 19–7**

| | | | | | |
|---|---|---|---|---|---|
| *Current Assets:* | | | *Current Liabilities:* | | |
| Cash | $ 3,000.00 | | Accounts Payable | $7,000.00 | |
| Accounts Receivable | 27,000.00 | | Notes Payable | 3,000.00 | $10,000.00 |
| Inventory | 15,000.00 | $45,000.00 | | | |
| *Fixed Assets:* | | | *Fixed Liabilities:* | | |
| Land | $10,000.00 | | Bonds | | 20,000.00 |
| Buildings | 12,000.00 | | *Net Worth:* | | |
| Delivery Equipment | 1,500.00 | | Capital Stock | | 20,000.00 |
| Furniture and Fixtures | 1,300.00 | 24,800.00 | Surplus | | 28,000.00 |
| *Investments:* | | | | | |
| Bonds | | 8,000.00 | | | |
| *Deferred Charges:* | | | | | |
| Prepaid Insurance | | 200.00 | | | |
| | | $78,000.00 | | | $78,000.00 |

Fig. 150

In Fig. 151 these balance sheets are arranged in comparative form and increases and decreases are shown in the third and fourth columns.

**Atlas Corporation**

COMPARATIVE BALANCE SHEET

**as at December 31**

| | 19–6 | 19–7 | Dr. | Cr. |
|---|---|---|---|---|
| *Assets:* | | | | |
| Current Assets: | | | | |
| Cash | $ 6,000.00 | $ 3,000.00 | | $ 3,000.00 |
| Accounts Receivable | 25,000.00 | 27,000.00 | $ 2,000.00 | |
| Inventory | 20,000.00 | 15,000.00 | | 5,000.00 |
| Land | 8,000.00 | 10,000.00 | 2,000.00 | |
| Buildings | 12,000.00 | 12,000.00 | | |
| Delivery Equipment | 2,000.00 | 1,500.00 | | 500.00 |
| Furniture and Fixtures | 1,500.00 | 1,300.00 | | 200.00 |
| Bonds | 6,000.00 | 8,000.00 | 2,000.00 | |
| Prepaid Insurance | 500.00 | 200.00 | | 300.00 |
| | $81,000.00 | $78,000.00 | | |
| *Liabilities:* | | | | |
| Current Liabilities: | | | | |
| Accounts Payable | $12,000.00 | $ 7,000.00 | $ 5,000.00 | |
| Notes Payable | 3,000.00 | 3,000.00 | | |
| Bonds | 20,000.00 | 20,000.00 | | |
| Capital Stock | 20,000.00 | 20,000.00 | | |
| Surplus | 26,000.00 | 28,000.00 | | 2,000.00 |
| | $81,000.00 | $78,000.00 | $11,000.00 | $11,000.00 |

Fig. 151

A better analysis of balance sheet changes is provided in the so-called statement of funds derived and applied, using the same balance sheets as shown in Fig. 151. There is shown in Fig. 152 a working paper in which the necessary analysis for preparing a statement of funds derived and applied is made.

From the work sheet, shown in Fig. 152, may be prepared a statement of funds derived and applied. Such a statement is shown in Fig. 153. It is assumed that the decline in the amount of delivery equipment and of furniture and fixtures represents a sale. It should be noted that the decrease in working capital of $1,000.00 provides funds to that amount.

The statement of funds derived and applied is referred to under other titles such as *Statement of Resources Derived and Applied*, also *Where Got, Where Gone* statement.

**Atlas Corporation**

WORKING PAPERS

**Funds Derived and Applied**

| | 19–6 | 19–7 | Changes Dr. | Changes Cr. | Working Capital Inc. | Working Capital Dec. | Funds Applied | Funds Derived |
|---|---|---|---|---|---|---|---|---|
| *Assets* | | | | | | | | |
| *Current Assets:* | | | | | | | | |
| *Cash* | 6,000 00 | 3,000 00 | | 3,000 00 | | 3,000 00 | | |
| *Accounts Receivable* | 25,000 00 | 27,000 00 | 2,000 00 | | 2,000 00 | | | |
| *Inventory* | 20,000 00 | 15,000 00 | | 5,000 00 | | 5,000 00 | | |
| *Land* | 8,000 00 | 10,000 00 | 2,000 00 | | | | 2,000 00 | |
| *Buildings* | 12,000 00 | 12,000 00 | | | | | | |
| *Delivery Equipment* | 2,000 00 | 1,500 00 | | 500 00 | | | | 500 00 |
| *Furniture and Fixtures* | 1,500 00 | 1,300 00 | | 200 00 | | | | 200 00 |
| *Bonds* | 6,000 00 | 8,000 00 | 2,000 00 | | | | 2,000 00 | |
| *Prepaid Insurance* | 500 00 | 200 00 | | 300 00 | | | | 300 00 |
| | 81,000 00 | 78,000 00 | | | | | | |
| *Liabilities* | | | | | | | | |
| *Current Liabilities:* | | | | | | | | |
| *Accounts Payable* | 12,000 00 | 7,000 00 | 5,000 00 | | 5,000 00 | | | |
| *Notes Payable* | 3,000 00 | 3,000 00 | | | | | | |
| *Bonds* | 20,000 00 | 20,000 00 | | | | | | |
| *Capital Stock* | 20,000 00 | 20,000 00 | | | | | | |
| *Surplus* | 26,000 00 | 28,000 00 | | 2,000 00 | | | | 2,000 00 |
| | 81,000 00 | 78,000 00 | 11,000 00 | 11,000 00 | | | | |
| *Decrease in Working Capital* | | | | | 1,000 00 | | | 1,000 00 |
| | | | | | 8,000 00 | 8,000 00 | 4,000 00 | 4,000 00 |

Fig. 152

**Atlas Corporation**

STATEMENT OF FUNDS DERIVED AND APPLIED

**Year Ended December 31, 19–7**

| | |
|---|---|
| *Funds Derived:* | |
| *Decrease in Working Capital* | 1,000.00 |
| *Sale of Delivery Equipment* | 500.00 |
| *Sale of Furniture and Fixtures* | 200.00 |
| *Increase in Surplus* | 2,000.00 |
| *Prepaid Insurance Used* | 300.00 |
| | 4,000.00 |
| *Funds Applied:* | |
| *Land Purchased* | 2,000.00 |
| *Bonds Purchased* | 2,000.00 |
| | 4,000.00 |

Fig. 153

The purpose of the statement of funds derived and applied is to give an accurate picture of the fundamental changes which occur between two balance sheet dates. It is a statement which appeals to the business man and one which he often reads to the exclusion of other types of statements. It is evident that before funds can be applied they must be derived, and it may be well to note that among the principal sources of funds are the following: (1) profits (increase in surplus), (2) sale of fixed assets, (3) sale of investments, (4) sale of capital stock, (5) decrease in working capital.

It also may be noted that among the principal ways in which funds may be applied are the following: (1) increase in working capital, (2) purchase of fixed assets, (3) losses (decrease in surplus), (4) purchase of investments.

**Balance Sheet Ratios.** A ratio is the expression of proportion of one sum to another, thus the ratio of 8 to 4 is 2, and the ratio of 12 to 3 is 4. In considering such a relationship as that existing between current assets and current liabilities it is sometimes difficult to picture the mathematical ratio of one sum to another because of the large amounts involved. Suppose, for example, that current assets equal $2,510,000.00 and that current liabilities amount to $1,324,000.00. It is found that the ratio of the larger to the smaller sum is 1.89+ to 1. This gives a clear picture of the relative size of the two sums and shows that the assets are practically 1.9 the

amount of the liabilities. There are several ratios which may be computed from the balance sheet as a means of analysis. Space will merely permit mentioning the following: (1) ratio of total assets to net worth, (2) ratio of fixed assets to long term debts, (3) ratio of net worth to total liabilities, (4) ratio of liabilities to receivables.

**Interpretation of the Income Statement.** Whereas the balance sheet shows the condition of an enterprise at a given date, the statement of profit and loss, or the income statement, indicates the changes which have taken place during a period of time, usually one month or one year. Under a satisfactory system of double entry accounting there are kept accounts with expenses and revenues as well as with assets, liabilities, and net worth. The purpose of the revenue and expense accounts is to record in as great detail as may be desirable all sources of income and all factors of expense, both operating and nonoperating. These income and expense accounts are sometimes called temporary proprietorship accounts because ultimately they increase or decrease proprietorship accordingly as they represent income or expense. The only reason for recording them first in income and expense accounts is to afford an explanation not only of the amount of the increase or decrease in net worth, but also to afford an explanation of the causes which result in such increase or decrease in net worth. These nominal accounts, after all necessary adjustments have been made to insure that there are no longer any mixed accounts, afford the information for making the closing entries in the journal. They are, by means of the closing entries, transferred to the debit and credit side respectively of the Profit and Loss account. The balance of the Profit and Loss account computed after all expenses and revenues have been carried to it represents the net profit or net loss for the period and therefore measures the increase or decrease in net worth.

The information shown in the Profit and Loss account, together with that in the Profit and Loss columns of the work sheet, affords all or most of the data required for the preparation of the statement of profit and loss. The Profit and Loss columns of the work sheet provide all of the information if the inventory totals and not merely the difference in the inventories are shown in these columns.

Perhaps the most satisfactory analysis to be made of the profit and loss statement is to reduce the principal items therein to percentages based on net sales as 100 per cent. In Fig. 154 is shown a statement of profit and loss for the X Company with such percentages computed.

**The X Company**

PROFIT AND LOSS STATEMENT

**Year Ended December 31, 19—**

| | | | | |
|---|---|---|---|---|
| *Sales* | | | 300,000.00 | 100.00% |
| *Less Cost of Goods Sold:* | | | | |
| *Inventory, Dec. 31, 19—* | | 40,000.00 | | |
| *Purchases* | | 200,000.00 | | |
| | | 240,000.00 | | |
| *Inventory, Dec. 31, 19—* | | 30,000.00 | 210,000.00 | 70.00% |
| *Gross Profit* | | | 90,000.00 | 30.00% |
| *Less Expenses:* | | | | |
| *Selling:* | | | | |
| *Advertising* | 3,000.00 | | | |
| *Salaries* | 5,000.00 | 8,000.00 | | |
| *Administrative:* | | | | |
| *Salaries* | 10,000.00 | | | |
| *Sundry* | 3,000.00 | 13,000.00 | | |
| *General:* | | | | |
| *Repairs* | 200.00 | | | |
| *Sundry* | 100.00 | 300.00 | 21,300.00 | 7.1 % |
| *Net Profit* | | | 68,700.00 | 22.90% |

Fig. 154

A study of Fig. 154 indicates the advantage in the use of percentage analysis of the income statement. This is because relationships are clearly expressed by percentages. The percentage of gross profit to net sales is 30 per cent; the percentage of net profit to net sales is 22.9 per cent. These ratios are important because they give an accurate indication of accomplishments. They can be compared with similar ratios achieved in preceding periods and thus be made a basis for the determination of policies.

# *Chapter* 20

# MANAGEMENT

**What Is Management?** The work involved in keeping accounting records is worthless unless the information thus made available can be used profitably. The modern business enterprise is such a complicated undertaking that it is impossible for one person or a group of persons to retain by memory all of the information needed for its efficient management. Even the man who works for a salary needs records even though these may be relatively simple in form. The individual who does not keep account of his income and expenses may find it difficult to make correct income tax returns, and even more difficult to satisfy the revenue agents who review his returns. When an enterprise is launched, it is to be presumed that the persons who have charge of it have satisfied themselves that the circumstances justify the undertaking and that its prospect of success is good. In order to achieve the greatest success in any given instance, it is necessary to have detailed information relative to the costs involved in each important activity. It is partly due to the necessity of having detailed costs relative to each important activity that large stores are subdivided into departments. Each department is in itself an enterprise and must justify its existence by producing a profit. If a department cannot be made profitable, it must be abandoned or reorganized. Not only must management have information essential to the understanding of an enterprise, but it must have this information in time to use it advantageously. Year-old statements make good history, but they are useless to the manager interested in correcting unprofitable trends in his enterprise. For managerial purposes, statements must originate monthly, weekly, and in some instances daily. To illustrate, cash may be considered. The person who is required to provide cash to meet all payments as they fall due must have a daily statement of all receipts and disbursements together with opening and closing balances of cash.

Management, however, involves many problems other than the correct accounting for cash receipts and disbursements. Several of these may be listed as follows: (1) providing adequate working capital, (2) determining depreciation policies, (3) determining dividend policies, (4) determining labor policies, (5) determining purchasing policies, (6) determining advertising and sales policies.

The following comments relative to the above-mentioned policies are made with a view to correlating accounting and management and thus to show the student how the formulation of managerial policies is based, to a large extent, on information of an accounting character.

*1. Providing Adequate Working Capital.* Uusally the treasurer of a corporation has the responsibility of formulating financial policies. No financial policy can be formulated and executed without taking into consideration the working capital position of the enterprise. For example, suppose that it is determined to enter upon a program of expansion which will necessitate the expenditure of $200,000.00 on buildings and equipment. Assume also that the present working capital of the enterprise is $150,000.00, that is, the excess of current assets over current liabilities. It is evident that the expenditure of $200,000.00 on fixed assets would more than exhaust the working capital and leave a deficiency therein of $50,000.00. Clearly some provision must be made for additional capital. The $200,000.00 must be secured by making an appeal either to investors by selling them bonds, or by appealing to stockholders through the sale of additional capital stock. If the funds are secured in this way, the working capital position of the enterprise will be protected.

Working capital is sometimes diminished through the operation of improper dividend policies. To illustrate, assume again that the working capital of an enterprise is $150,000.00 and that its surplus is $300,000.00. If the board of directors decides to pay $150,000.00 in dividends, it is evident that the working capital will disappear. Such a policy would place the enterprise in an embarrassing position and possibly compel it to undergo a reorganization.

These illustrations make evident the need of a conservative policy relative to the preservation of working capital. It is evident,

however, that such a policy is not likely to be enforced unless the facts are made clear by means of up-to-date financial statements.

2. *Determining Depreciation Policies.* Most modern enterprises invest a large part of their total capital in fixed assets, such as land, buildings, machinery, and other equipment. This investment must be preserved and its preservation hinges upon the policy which the concern follows relative to depreciation. Expenses which require the current disbursement of cash cannot be neglected but depreciation expense can be neglected easily, sometimes for a considerable period of years. This, however, does not mean that depreciation is any less an expense than is labor or rent. If a building costs $10,000.00 and it has an estimated useful life of twenty years and no salvage value, it is evident there occurs each year depreciation amounting to approximately $500.00. If this is neglected, profit is understated by that amount and dividend policies are likely to be more liberal than they would be if profits were not overstated. When a proper adjusting entry is made at the end of each accounting period for depreciation, it results in charging this expense along with others to the Profit and Loss account for the period in question. If, after all expenses have been covered, there still remains a balance known as net profit, it is evident that depreciation for the period has been earned. This takes the form usually of cash, since under modern systems, barter is of little importance. As a consequence, the decline in value which occurs in the fixed asset group is offset by an increase in working capital. To summarize briefly, working capital may be diminished through the purchase of a fixed asset, but if proper depreciation charges are made periodically the working capital will be increased as the asset wears out.

The determination of proper depreciation rates is practically impossible unless adequate records of plant and equipment are kept. This is proved by the findings of expert appraisers and also by the findings of representatives of the Bureau of Internal Revenue in connection with the administration of the income tax. Many business men are installing plant ledgers which provide a separate account for each significant fixed asset. This makes it possible to avoid using blanket depreciation rates and to use instead rates which are applicable to the specific asset in question, concerning

which there is provided all necessary information relative to date of installation, cost, estimated salvage value, and estimated useful life.

The foregoing considerations indicate the importance of determining for a given enterprise a well-thought-out policy relative to depreciation. Such a policy cannot be made effective unless satisfactory records are used.

*3. Determining Dividend Policies.* A corporation must determine what its policy will be relative to the treatment of surplus, namely, whether it shall be retained in the business and thus provide a source of funds for expansion, or whether it shall be distributed to the stockholders in the form of dividends. In case of closely held corporations, that is, corporations whose stocks are held by relatively few people, dividend policies can be altered frequently without difficulty. In case of corporations whose stocks are widely distributed among hundreds or thousands of stockholders, many of whom depend upon dividends for their living, a dividend policy once determined upon should not be changed unless made necessary by altered conditions. For example, if a corporation whose capital stock is widely held settles upon a policy of paying dividends of 7 per cent annually on its stock, it should, if possible, pursue this policy year after year. In case of an unusually profitable period, an extra dividend may be declared and the stockholders informed that this extra dividend is temporary and may not be continued.

As a rule, a corporation should not distribute all of its earnings as dividends. Usually some of its earnings should be retained to strengthen the working capital position and thus enable it, when conditions warrant, to expand its plant or reduce its debts. In other words, surplus is an important source of funds and only in exceptional cases is a concern justified in applying all of the funds thus provided to pay dividends.

*4. Determining Labor Policies.* Labor constitutes a large part of manufacturing costs. As has been shown, labor is either direct or indirect. The correct determination of direct labor costs and also of indirect labor costs cannot be accomplished, except where records are properly devised for the recording and distribution of these costs. The item of labor is sufficiently important to make it desirable

to provide for its constant analysis. If this is not done, labor costs become excessive.

*5. Determining Purchasing Policies.* Whether a concern is engaged in retailing or in manufacturing, it must constantly buy materials and supplies. There must be coordination between purchasing, manufacturing, and marketing, otherwise excessive amounts of capital are tied up in inventories. This is true not only of finished goods inventories, but it is also true of raw materials and inventories of work in process and of merchandise inventories. The routine procedure involves the careful checking and vouchering of all invoices. Without some such plan as has been described in the chapter on the voucher system, purchasing may be carelessly done. In any event, there must be detailed information relative to all purchases, as well as statistical information, which will enable management to formulate purchasing policies.

*6. Determining Advertising and Sales Policies.* In order to promote sales, it is necessary to keep account of the sales according to classes of merchandise, as well as to secure information relative to geographical areas in which sales promotion may be profitable. Advertising policies therefore must be coordinated with sales effort in order that the greatest amount of benefit may result from any given amount spent on advertising. For example, if an extensive advertising campaign is promoted for a given article and thereafter the concern is unable to provide the article in sufficient quantity to meet the demand, much of the advertising cost is wasted. The results of sales campaigns can be learned only where accurate data is provided for analysis. Only where a system of double entry accounting, together with a suitable classification of sales accounts, is in effect is the desired information forthcoming.

**Correcting Wrong Trends.** There are many ways in which wrong trends in business may occur. To illustrate, emphasis may be placed on the sale of unprofitable articles, whereas it should be placed on the sale of profitable articles. Again, expenses may be permitted to become excessive through carelessness and failure to check constantly on expenditures of this character with a view to keeping them down to a minimum. Waste is also a source of serious loss. Waste may take the form of lost power, lost merchandise, lost

accounts due to inadequate measures to make collections, and it may result from numerous other causes. Successful business is not self-perpetuating; but it must be constantly checked and revised in view of existing facts and changing conditions. Experience serves to establish normal percentages of expense in relation to income and these should not be exceeded, except where unusual conditions or changing conditions warrant. This may be illustrated by reference to the income statement shown in Fig. 154, where cost of goods sold is shown to be 70 per cent of sales and where expenses are shown to be 7.1 per cent of sales. Suppose that in the following year cost of goods sold increases to 75 per cent of sales and that expenses increase to 10 per cent of sales. This would leave a net profit of only 15 per cent. Such a trend in costs and expenses deserves serious consideration. It is because of the importance of detecting such trends at the earliest possible moment that monthly statements are frequently required.

In connection with the management of working capital, trends are equally important and must be checked constantly. Suppose, for example, that at the end of a given year the working capital ratio is 3 to 1; at the end of the next year 2 to 1; and at the end of the next year 1.5 to 1. This unfavorable trend must be reversed or trouble is sure to result. Of course, from month to month there may be a slight downward fall followed by a slight upward trend without indicating any serious development. Where month after month the working capital grows less, there is obviously something wrong in the financial management of the enterprise. Such a trend may be due to constant encroachment upon working capital for the benefit of the fixed asset division of the balance sheet, or it may be due to improper debt policies, or even to increased dividend policies. Whatever the cause, it should be located and corrected.

Treatment of depreciation sometimes gives rise to wrong trends. For example, the reserve may be inadequate or there may be no provision whatever for this important item of expense. The true character of depreciation, as an operating expense, must be appreciated and depreciation must be treated accordingly. Overstatements of profits year after year lead to ultimate insolvency and bankruptcy. Adequate provision made each month for depreciation

goes a long way toward strengthening the financial foundations of an enterprise.

**Daily Statements.** Some trends must be checked daily. This is true, for example, of cash. The manager must have on his desk each morning a complete detailed statement of the receipts and disbursements for the previous day. This is essential to the satisfactory management of cash. Of course all receipts should be deposited in the bank and all disbursements should be made by check, petty cash disbursements being handled on an approved plan. Other statements also may be required daily, as for example, cash and credit sales by departments, as well as the amount of sales by clerks. The exact character of daily statements must be made to depend upon the nature of the enterprise. At any rate, their importance is great and adequate management of current affairs is impossible unless based upon the facts which such statements afford.

**Treatment of Debts.** As has been explained, debts usually may be classified broadly into short-term and long-term obligations. Short-term, or current, debts are regarded generally as including all debts which fall due and must be paid one year from date. Those debts whose maturity is more than one year hence are long-term debts. The problem of the management of debts is usually an important one because few concerns are able to operate altogether on their own capital.

The treatment of short-term obligations requires the constant attention of the management because of the savings which may be made by securing discounts through prompt payment. If, for example, a concern makes it a policy to take all cash discounts, a plan must be followed whereby each item will be called to the attention of the proper party as the date of payment approaches. Suppose, for example, that an enterprise is operating under the voucher system. After a voucher has been entered in the voucher register, it should be placed in an unpaid voucher tickler on the desk of the disbursing officer where it will be called to his attention by being placed back of a tab indicating the date on which it must be paid. Some concerns are able to pursue such a policy consistently, others may not be able to take all cash discounts. Where all cash discounts are taken as a matter of policy, a Discount on Purchases column

may be carried in the voucher register. Where there is any doubt as to the ability of the concern to take all cash discounts, the Discount on Purchases column should be placed in the check register.

Now and then it becomes necessary to borrow money at a bank. The recognized function of a commercial bank is to lend funds to business enterprises to enable them to pass through temporary periods of shortages in cash. For example, if a merchant makes heavy purchases of merchandise preceding the holiday period, he may be compelled to borrow at his bank in order to secure cash to carry him along until he can realize upon the merchandise purchased. Bankers are interested, therefore, in the working capital position of the concerns to which they are considering the extension of loans, because short-term loans must be liquidated almost invariably out of current assets. The statements which bankers require from their customers are designed usually to make clear the status of their customers' ability to meet their current liabilities.

The treatment of long-term debts is one which requires the most careful consideration. The justification for incurring long-term debts must be found in the requirements of the enterprise. Among the possible uses to which money thus secured may be put are the following: (1) increase working capital, (2) finance the purchase or construction of fixed assets, (3) pay off existing long-term indebtedness.

*1. Increase Working Capital.* Working capital cannot be increased through short-term loans, since such loans result in an equal increase in current assets and current liabilities. Whether an enterprise is justified in selling bonds to increase its working capital depends upon the manner in which it uses its working capital. Assuming that a concern has weakened its working capital position through the constructing or purchasing of fixed assets which might properly have been financed in the first place by the use of bonds, it is entirely proper to issue bonds in order to bring working capital up to its original amount.

To illustrate, assume that on January 1 of a given year the X Corporation has working capital amounting to $500,000.00, but that during the year $475,000.00 of this is used to finance the construction of a new factory, leaving only $25,000.00 in working

capital at the end of the year. The X Corporation, in order to secure a satisfactory working capital position, decides to sell $500,000.00 in bonds, which it disposes of at their par value. After the sale of these bonds, the working capital amounts to $525,000.00 and the position of the corporation is practically the same as if it had sold the bonds in the first place and used the proceeds to construct the factory.

Sometimes the lack of working capital arises out of mismanagement or operating losses. This is a more serious situation because a corporation in this condition does not enjoy a very good credit standing; and if it does sell bonds it has thereafter no additional fixed assets to be used as security for such bonds. In such a case, it is better to effect a gradual improvement in the working capital position through the retention in the business of profits and through general economies.

*2. Financing Purchase or Construction of Fixed Assets.* The justification for incurring long-term indebtedness for the purpose of financing fixed assets is found in the presumption that such fixed assets will be properly employed and that as they depreciate the depreciation will be earned and thus provide, in effect, a fund which can be used to pay off the bonds. For this reason it is generally unwise to issue bonds having a term longer than the life of the asset which they are employed to finance. To illustrate, assume that a corporation issues $100,000.00 of bonds at par to construct a building which will have a useful life of 30 years. The term of the bonds should not be more than 30 years, otherwise, after the building has been abandoned, the debt incurred to construct it will still be in existence.

If a corporation makes proper provision for the liquidation of a debt, it will not find itself under the necessity of attempting to refund or extend the loan later on under unfavorable circumstances, although it is true that such debts frequently are extended or refunded.

The creation of a sinking fund is the most usual plan whereby corporations prepare to liquidate bonded indebtedness. Such sinking funds usually are placed in the hands of a trustee who manages the fund for the benefit and protection of the bondholders. Sometimes a sinking fund is permitted to accumulate through the addition of interest earnings until the entire amount of the bond issue

matures. Generally, however, the trust deed permits the trustee of the sinking fund to use it when favorable market prices make it possible for him to redeem a portion of the outstanding bonds. This is a safe procedure, since the investment, in effect, is in the same bonds which it is the purpose of the fund to liquidate.

If a corporation sets aside a sinking fund for the payment of the bonds sold to finance the construction of a building and at the same time sets up a reserve for depreciation on the building, it is in a sense making double provision for the payment of the debt. In the first place, there is the sinking fund which should be carried in the fixed asset division or in the investment division of the balance sheet. In the second place, it is strengthening its working capital position through the depreciation charge. A corporation which pursues such a policy should be in a position at the end of the life of the building to pay off the indebtedness originally incurred to construct the building and at the same time to finance the construction of a replacement without incurring any further indebtedness.

*3. Paying Off Existing Long-Term Indebtedness.* Issuing bonds for the purpose of paying off existing long-term indebtedness is sometimes justified, sometimes not. As has been explained, the term of indebtedness should not be greater than the life of the asset which the debt finances. There may be exceptions to this rule, but exceptions should be made only where justified by unusual circumstances. Extending existing indebtedness and, at the same time, incurring additional indebtedness is a dangerous policy, because a corporation which pursues such a policy is liable to find its debt structure top-heavy. There is a point beyond which financing through the increase of fixed indebtedness is dangerous. Ordinarily, if a bond issue cannot be paid off without new financing, the new financing should take the form of an issue of stock. This diminishes fixed indebtedness and increases net worth, a trend which generally means greater financial stability, especially where the increase in net worth takes the form of common stock. A corporation should watch carefully the ratio of net worth to indebtedness as well as the ratio of current assets to current liabilities and the ratio of fixed assets to fixed liabilities. Although considerable flexibility in these ratios is permissible, extreme variations from what are generally

regarded as safe ratios should not be tolerated. To illustrate, if a safe ratio of current assets to current liabilities is 3 to 1, a 1½ to 1 ratio should not be permitted. Likewise, if a ratio of net worth to fixed liabilities of 2 to 1 is regarded as satisfactory, a ratio of net worth to fixed liabilities of 1 to 2 should be viewed with alarm.

**Budgeting Problems.** Accounting data is necessarily historic in character, being the record of past accomplishments. If, however, accounting data is put to its best use, it should enable the manager to lay plans for future operations. Planning for the future in business is known as budgeting. Budgeting consists in making estimates of future sales and future expenses based on the best available information.

To illustrate this, suppose that in 19–4 net sales amount to $320,000.00, in 19–5 to $340,000.00, and in 19–6 to $355,000.00. There is reason to believe that there will continue to be a normal growth in the business, and it is estimated that sales in 19–7 will amount to $370,000.00. If this estimate is a reasonable one, then it is evident that all expenses and costs of operating can be regarded as functions of this amount, that is, they can be related to it on a percentage basis. It should, therefore, be possible not only to estimate sales for 19–7 at the foregoing figure, namely, $370,000.00, but it also should be possible to estimate all costs and expenses involved in producing the goods required to meet the above-mentioned volume of sales. In other words, a tentative profit and loss statement is projected into the future and it is made to serve as a measure of activity. Employing the actual profit and loss statement for 19–6 as a basis of procedure, the tentative profit and loss statement for 19–7 may be prepared by stating estimated net sales at $370,000.00 and computing estimated expenses for 19–7, after considering the percentages which the various items of cost and expenses in the actual profit and loss statement for 19–6 represent, as related to actual net sales for 19–6.

In Fig. 155 is shown the actual profit and loss statement for the A, B, C Company for the year ending December 31, 19–6, and also the estimated, or budgetary, profit and loss statement for the year 19–7. In this instance, the items are all increased by 10 per cent, but in practice there may be some variations from such a fixed per-

**A, B, C Company**

PROFIT AND LOSS STATEMENT

**Year Ended December 31, 19–6**

| | 19–6 (Actual) | | 19–7 (Estimated) | |
|---|---|---|---|---|
| *Gross Sales* | 1,000,000.00 | | 1,100,000.00 | |
| *Less Sales Returns and Allowances* | 4,000.00 | | 4,400.00 | |
| *Net Sales* | | 996,000.00 | | 1,095,600.00 |
| *Cost of Goods Sold* | | 703,300.00 | | 773,630.00 |
| *Gross Profit* | | 292,700.00 | | 321,970.00 |
| *Operating Expenses* | | | | |
| *Selling Expense* | 45,500.00 | | 50,050.00 | |
| *Administrative Expense* | 77,000.00 | | 84,700.00 | |
| *Organization Expense Amortized* | 3,000.00 | | 3,300.00 | |
| *Total Operating Expense* | | 125,500.00 | | 138,050.00 |
| *Net Profit on Operations* | | 167,200.00 | | 183,920.00 |
| *Financial Expense* | | 15,000.00 | | 16,500.00 |
| | | 152,200.00 | | 167,420.00 |
| *Financial Income* | | 8,000.00 | | 8,800.00 |
| *Net Profit for Year* | | 160,200.00 | | 176,220.00 |
| *Less:* | | | | |
| *U.S. Taxes—Income* | | 10,000.00 | | 11,000.00 |
| | | 150,200.00 | | 165,220.00 |

Fig. 155

centage of increase, due to planned economies or unusual circumstances.

This book is not a treatise on budgeting. The purpose here is simply to indicate how accounting data may be used as a basis for the preparation of budgets. The budget may be subdivided in as detailed a manner as circumstances warrant. In practice, budgets vary from the simplest forms of estimate, prepared by small enterprises, to elaborate budgets of large corporations, based on departmental forms of organization.

# INDEX